

[COMMITTEE PRINT]

FEDERAL RESERVE STRUCTURE AND THE  
DEVELOPMENT OF MONETARY POLICY:  
1915-1935

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STAFF REPORT  
OF THE  
SUBCOMMITTEE ON DOMESTIC FINANCE  
COMMITTEE ON BANKING AND CURRENCY  
HOUSE OF REPRESENTATIVES  
92d Congress, First Session



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## LETTER OF TRANSMITTAL

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*To Members of the Domestic Finance Subcommittee:*

Transmitted herewith for the consideration of the Subcommittee on Domestic Finance is a staff study entitled *Federal Reserve Structure and the Development of Monetary Policy: 1915-1935*.

This study grew out of an effort to examine the origins of the Federal Open Market Committee. An examination of the materials in the archives of the Board of Governors of the Federal Reserve System—stenographic records of meetings and conferences—indicated that the record of the System's decision-making process during the first two decades of its existence is probably more complete than that of any other agency of Government. Yet, these records were difficult to obtain and it would appear that heretofore they have not been available in their entirety for research in the field. The material provides an incredibly rich source of information about the System during this period—its goals and conflicts, the limitations of its powers and the means which it found to transcend them. Some of the views put forward in these conferences were perhaps naive and others have ceased to be relevant. Many, however, are current and relevant to an amazing degree as are the events which provided the stimulus for actions. Discussions of interest rates, the reserve positions of member banks and prices as target variables for monetary policy contribute to our understanding of these factors in current policy. One notes with particular interest similarities between developments in 1920 and in 1970—a decline in production and employment, coupled with rising prices and high interest rates.

The present study focuses on the structure of the Federal Reserve System. It makes clear that the System evolved in ways which were not foreseen in enactment of the original Federal Reserve legislation and that this evolution was in two important respects contrary to the intention of that legislation. Officers who were not provided for by law—the governors of the Federal Reserve banks—created new and extra-legal institutions—the Conference of Governors and the several open market committees—which transformed the Federal Reserve from the intended regional system into a central bank. The creation of these institutions also meant that the powers of the System were shifted from the Federal Reserve Board to groups more closely allied with private banking interests, and that thus the intended public control of the banking system was lost. The Federal Reserve grew to resemble the Aldrich central bank plan of 1912, which had been firmly repudiated in a presidential election in which the creation of a reserve banking system was the most important issue.

The alteration in the Federal Reserve's structure was largely the work of Governor Benjamin Strong of the Federal Reserve Bank of

New York and Secretary of the Treasury Andrew Mellon. During the 1920's, the System as they had shaped it worked well enough, but in the 1930's it proved to be disastrous and required extensive legislative revision. The Banking Act of 1933 attempted to reinstate the regional structure of the System while permitting the influence of private banking interests on policy to be perpetuated. The 1935 Act, reflecting more advanced economic theories, sanctioned the centralization of System operations through the open market authority, but attempted to reinstate the original Federal Reserve structure to insure that all its powers would be controlled by officers directly appointed by the President and confirmed by the Senate. With respect to this latter intention, the legislation as enacted was a failure.

Those with the interest and patience to examine a detailed account of past events may find this study instructive. It is not always easy to determine the structural strength of the Federal Reserve System divorced from the men who administer it. The following analysis makes such an attempt.

The views and conclusions found in this study do not necessarily express the views of the Committee or any of its individual members.

This study was prepared by Jane W. D'Arista, Staff Member, House Committee on Banking and Currency.

Sincerely,

A handwritten signature in cursive script, reading "Wright Patman". The signature is written in dark ink and is positioned above the printed name.

WRIGHT PATMAN, *Chairman.*

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# FEDERAL RESERVE STRUCTURE AND THE DEVELOPMENT OF MONETARY POLICY

## INTRODUCTION

This book analyzes Federal Reserve structure, policy, and functioning in the 1915–1935 period. The structural factors, prejudices and views about monetary processes which combined to shape Federal Reserve actions in the 1915–1935 period are examined thoroughly and incisively. Sight is never lost of the relevance of the factors and ideas underlying the Fed's actions to the behavior of money supply and interest rates and the aggregates of ultimate concern to all of us: prices, production and employment. But the emphasis of this book is on the political, institutional and intellectual forces that shaped the Fed's actions, not their effects. The history of our economy's reactions to Federal Reserve actions has been amply documented and analyzed elsewhere. This study focuses on the underlying determinants of these actions in the 1915–1935 period, and in doing this makes a significant contribution to knowledge.

Add also that in examining the underlying forces the author has relied very heavily on primary information—the stenographic records and minutes of conferences and meetings of the ranking officers of the Federal Reserve, including especially the annual Conferences of Reserve bank Governors and meetings of the Open Market Policy Committee. These records and documents had never in their totality been analyzed by anyone until this inquiry was made. Extensive use of these sources enriches the study and makes it a valuable reference for future research.

The crucial struggles and themes which shaped monetary policy in the 1915–1935 period which this study brings into common view are—to summarize—the following. The parent or trunk issue concerns the proper role of the Federal Reserve—should it be essentially passive or should it actually try to achieve economic goals. From the standpoint of the System's structure the trunk issue involves the location of decision-making power. From the standpoint of the intellectual biases and analyses that the officers of the Fed apply to questions of the moment, the trunk issue involves the validity and usefulness of the real bills doctrine vis-a-vis countercyclical theories of central banking. In turn, this latter raises the question of the proper indicator and target of Federal Reserve actions. These questions are elaborated upon briefly below as illuminated by the study.

1. *The struggle for power.*—A power struggle began almost immediately after the Reserve banks opened for business in November, 1914 when the Federal Reserve Board pressured the Reserve banks for lower and more uniform discount rates and the Reserve bank Governors

resisted. The Board won this round but lost the struggle. The Reserve banks won the struggle for power by dominating the System's open market operations.

Open market operations, whereby the central bank buys and sells Government securities and eligible private debt issues, define the principal central banking technique for influencing the volumes of high-powered money, money supply and the cost and availability of bank credit. Open market operations were impelled initially by the Reserve banks wanting to accumulate earning assets. The *modus operandi* that was established early in 1915 was for purchases to be made by the New York Reserve bank and allocated among all Reserve banks. Holdings included investments in bankers' acceptances, municipal warrants and Government bonds. The New York bank was to constrain purchases so as not to bid down interest rates. The Board endorsed this arrangement, apparently without realizing that in doing so it was giving the Reserve banks, and especially New York, control over the System's most powerful policy instrument; open market operations were not then quantitatively important. In contrast to current holdings of over \$65 billion of Government bonds, the System's portfolio of bonds and acceptances remained below \$500 million prior to the outbreak of World War I and rose to a high of approximately \$900 million in 1919 (see Appendix C).

Both Reserve bank control of open market policy and centralization of operations in New York were challenged in the 1920's. New York's attempt to dominate open market policy was resisted by other Reserve banks. In 1921 they repudiated the allotment proposal and made purchases in their own districts to develop local markets in bankers' acceptances and other eligible securities. In the first half of 1922 substantial purchases of Government securities were made independently by the various Reserve banks. Interest rates declined. The economy was just beginning to emerge from the 1920-21 depression. Nonetheless, Secretary of the Treasury Mellon called the Board's attention to this "easy money" policy and elicited legal opinion that the Board could restrict Reserve bank open market operations. The Governors, excepting Strong of the New York bank, defended the purchases as necessary "for income purposes." Strong argued that the purchases were necessary so the New York Reserve bank would have on hand securities to sell to tighten credit without raising the discount rate if credit conditions should later warrant. (Subsequently Strong pointed out that the purchases had decreased interest rates and accelerated the economy's recovery.) Under pressure to establish order in the money market from Secretary Mellon, and as a result also of Governor Strong's persuasiveness in arguing the case for joint action through New York, the Reserve bank Governors established a committee to work out an orderly method for executing individual Reserve bank orders to buy and sell Government securities. This was the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities by Federal Reserve Banks organized in May, 1922, and consisting of the Governors of the New York, Boston, Philadelphia, Chicago and Cleveland banks.

In February, 1923 one of the Reserve banks by-passed the Committee and made purchases for its own account. Secretary Mellon reacted

by asking the Board to prescribe regulations prohibiting individual Reserve banks from making purchases for their own accounts without express approval of the Board. The Board responded by dissolving the Committee on Centralized Execution and authorizing formation of the Open Market Investment Committee. This latter committee consisted of the same Governors as the predecessor committee. It was established to handle open market transactions for the entire System.

There remained in question, however, the power of the Board to limit or otherwise supervise the Committee's actions. The Committee had met only once when in May, 1923 the Board instructed it to liquidate all Reserve bank holdings of Government securities. The instruction was carried out. Momentarily it appeared that the Board would set policy and the Committee act as its agent. But the Board's power over open market policy was soon dissipated. Beginning with the Dallas bank in September, 1923, individual Reserve banks, pressed for income, began to request the Committee's approval to make purchases. The Committee in turn sought the Board's approval for such purchases. Then, beginning in November, 1923, the Committee voted to make purchases to obtain earning assets for all Reserve banks by way of forestalling further requests by individual Reserve banks. Thus the Board began to pass on the Committee's policies rather than to initiate policy. In October, 1924 the Committee asked for authorization to *buy or sell* \$100 million of securities as conditions warranted and the Board approved. De facto if not de jure the Committee was now independent of the Board. The Committee openly asserted its independence in 1926 when it rejected the Board's request that it meet in Washington and also meet with the Board. Public control over monetary policy via formulation by the Presidentially appointed Federal Reserve Board, including the Secretary of the Treasury as ex-officio member, a cornerstone of the original Federal Reserve Act, was thus rendered meaningless, and remained so until given partial substance by the 1935 Banking Act.

Meanwhile the Reserve banks had grown increasingly rebellious about the Committee's powers. The smaller Reserve banks resented that they had no say. The larger ones, those on the Committee, resented New York's domination of Committee policy. The Boston, Chicago and Philadelphia banks tried to make purchases on their own. Governor Strong, however, persuaded the Board to hold them in check. New York's dominance resulted partly because policy was carried out in New York and partly because of Governor Strong's immense intellectual and leadership powers.

But after Governor Strong's death in October, 1928 New York was unable to dominate open market policy. In March, 1930 the Investment Committee was dissolved and the Open Market Policy Committee, comprised of all twelve Reserve bank Governors, was established to conduct open market operations. This arrangement was sanctioned by the Banking Act of 1933 which gave legal recognition for the first time to the existence of an open market committee. But the Open Market Policy Conference failed to coordinate these operations and was replaced by the present twelve man Federal Open Market Committee, comprised of the seven Board members and five Reserve bank presidents, which was established by the 1935 Banking Act.

2. *Passivity: The wrong constituency, the wrong people in power.*—The struggle for power so briefly chronicled above had important repercussions on Federal Reserve policy in the years under study. In the pre-World War I years, the majority of Reserve bank governors, reflecting traditional banking prejudices and views, saw the Federal Reserve as a bankers' bank, passively responding to member bank loan requests at penalty rates. The important exception was Governor Strong who, like many of the System's politically appointed Board members, viewed the Federal Reserve as a public agency created by Congress to achieve economic goals. Strong understood from the beginning that open market operations as well as discount rates could be used countercyclically, and he argued that they should be. As early as 1915 he observed that, ". . . Had the reserve banks been in operation a few years and accumulated a considerable loan and investment account their policy under present conditions should be to withdraw funds from the money market for the purpose of correcting undue ease of money rates, which is only too frequently accompanied by unsound expansion and speculation." (See Chapter 1, part 2.)

To anticipate briefly the study's penetrating narrative, the governors, with, however, Strong not taking part in the decision, opposed direct Reserve bank purchases of Treasury certificates in World War I. As put by Governor Aiken of Boston, they felt that "our resources should be as free as possible for the commercial needs of the country." The Board chose to circumvent the Governors' passion for passivity in this instance rather than confront it directly. Under a plan devised by Board member Paul Warburg, member banks were able to obtain loan accommodation from Reserve banks using Treasury securities as collateral at a lower rate than the rate paid on the collateral.

This "preferential rate" assured the Treasury's success in its wartime borrowing efforts. It also assured that member banks would profit from the war. Regardless of one's view of the morality of this aspect, the Warburg scheme was completely contrary to the view of the Reserve banks that the Federal Reserve is or should be a passive agency responding to member bank loan demand at a penalty rate. In the war, then, the System's public members took charge and used its power consciously if circuitously to achieve public goals. The public was, through the President who appointed them, their constituency.

In 1919 the Board favored using "moral suasion," or "direct action" as it was also called, to control credit while the Governors wanted to reinstate the penalty discount rate. The discount rate was raised to a penalty rate and the preferential rate eliminated. By June, 1920, the discount rate on commercial paper in New York had been increased to 7%, up 3 points from the 4% rate in effect the previous fall. There is no question, of course, that some sort of action was required to restrain the ongoing inflation that was inherited from the wartime preferential rate finance program still in force. There is also no question but that moral suasion is not really workable, as many of the Governors saw. But the more important point which the narrative brings into view is that it was only through the happy accident of the prevailing (but ephemeral) consonance of their commitment to the passive penalty rate doctrine and the then current appropriate countercyclical dis-

count rate policy that the Reserve bank Governors led the System to "lean into the winds" in 1919. There is no hard evidence that the Governors had become truly activists.

By May, 1920 the economic winds had shifted. The need for an active antidepression monetary policy became increasingly urgent as time passed. But the System proved incapable of dealing promptly with the 1920-21 depression and deflation. Its response to the economic slump was predicated on the passive operating rule that the central bank can lend freely at a penalty rate. It kept discount rates up until late 1921, though reducing them to 6% in May. As a consequence, credit was restricted and money supply fell. Reserve officials argued that this wasn't their fault because "the volume of credit extended by the Federal Reserve System is under the exclusive control of the member banks in the System." (See Chapter IV, Part 3). Their argument ignores the crucial fact that the Reserve banks control the quantity of credit supplied to member banks and hence has zero credibility. The study makes one final point on this episode: to wit, that the small rate reductions of May, 1921, and the dramatic decreases in late 1921 were initiated by the Board; in fact Governor Strong and nine of the other Reserve bank Governors opposed the May cuts. Thus the episode shows the importance of locating the System's decision making powers with its public members. Though further removed from the electorate than would appear desirable, the public members proved far more flexible and responsive than the Reserve bank Governors in meeting the 1920-21 crisis.

The growth of open market operations after 1921 provided a new dimension to the meanings of active and passive central bank policies. In May, 1923, as noted above, the Board instructed the Committee to liquidate its entire portfolio and the instruction was carried out. Strong, anxious for the Board's backing in his efforts to centralize open market operations, argued that although he did not think the System should act to influence rates, since the fall in rates to May, 1922 had been due to System action, there was now justification for acting to raise rates by liquidating the portfolio. Thus Strong was able to fit an activist policy into a passive framework. The Governors went along.

Whether liquidation of the portfolio was largely responsible or not, a recession began in the spring of 1923 which lasted until the summer of 1924. In November, Strong argued that the System should be prepared to purchase Government securities to relieve pressure on member banks by enabling them to reduce their debt to the System, i.e., discounts. Their free reserves would rise—though Strong did not refer to free reserves. The Governors, however, preferred to use interest rates as their indicator of the need for aggressive antirecession policy. They argued that since interest rates were stable there was no need for action. In the framework of open market policy, passivity coincides with stable interest rates.

Nonetheless the System began to purchase securities beginning in December, 1923. The purchases were made because Reserve banks needed earning assets, not for countercyclical reasons. But they appear to have had a positive countercyclical effect. The recession ended, as noted, in the summer of 1924.

The Board had now taken a back sea in policy making and the new passive operating rule of the Governors continued in force for the next couple of years. From the summer of 1924 until the fall of 1926 interest rate stability was the primary goal of open market operations, and interest rates moved within a narrow range in this period. This was a time when underlying forces acted to make interest rate stability consistent with minimal inflation and unemployment. There were changes in open market policy but they were neither sharp nor enduring during these two years. Moreover, the study brings out the fact that the policy shifts were motivated for the most part by interest rate developments. Open market sales in the fall-winter, 1924-25 period were intended to firm up rates. Purchases beginning in the spring of 1925 were prompted in part at least to correct emerging international interest rate differentials. Last, sales beginning in the fall of 1925 were made to moderate the rise in stock prices—i.e., the fall in equity rates.

The happy coincidence of interest rate stability and minimal inflation and unemployment endured only to the fall of 1926. At this time underlying credit market forces acted to reduce interest rates. Operating under the new passivity doctrine the System engaged in open market sales to prevent rates from falling. The result was a sharp business recession lasting from October, 1926 to November, 1927. The System did not move in a substantial way to correct this downswing until August, 1927. It was paralyzed by the new doctrine of passivity expounded by the Governors, ruling out expansionary actions as long as interest rates are stable or declining as was the case until the summer of 1927.

Five months after the end of the 1926-27 recession, in April, 1928, the money stock reached \$26.6 billion. As the narrative notes, "It fell below this level until July, 1929 when it reached \$26.7 billion and then to \$26.4 billion. The stage was thus set." (See Chapter IX, part 3). The Reserve bank Governors, perhaps because of the death of Benjamin Strong in October, 1928, saw no risk of deflation and depression in this development. Rather, open market policy in this period was dominated by an attempt to curb stock market speculation. This concern reflects what is perhaps the basic intellectual bias of the banking school of monetary policy; to wit, the real bills doctrine. More on this doctrine later.

We approached and entered the depression years with the wrong people dominating monetary policy. Action was needed; aggressive expansionary action. But the Reserve bank Governors who had jurisdiction over open market operations were too deeply committed to passivity to do what was required. The biases of their commercial banking background and constituency called for no action with interest rates stable or falling. And the Board had been too long in the back seat of decision-making to take charge. Thus in September, 1930 the Open Market Policy Committee ignored Adolph Miller's cogent argument that "in times of depression, particularly, a money rate is a very imperfect indicator of the true state of credit. Money is sleeping and it is conceivable that a part of a constructive program is to wake it up and make it do something and that you may be misled into a false sense of the soundness of the general money situation because rates are low." (See Chapter X, part 2). President Hoover was right

when he observed that, as it had evolved since 1915, the Federal Reserve proved to be "a weak reed for a nation to lean on in a time of trouble." (See Chapter XI, part 2). It still is, as discussed next.

3. *Real bills then and now.*—The present study brings into common view the fact that underlying the erroneous and injurious policies of the System in the 1915–1935 period in almost every instance was the real bills doctrine. This is perhaps the book's most important contribution and it is a very important one.

The real bills doctrine asserts that credit should be supplied to provide for the real needs of business, not for speculative activity. Loans that would be repaid out of the future earnings of the assets being funded are valid and useful. Loans to carry speculative assets such as common stocks are not. On the surface it has appeal.

But closer analysis reveals that the doctrine is erroneous and produces great harm when used as an operating rule by the central bank. The doctrinal error is that the real needs of business, funds for working capital, to carry inventories and so forth, are high and rise higher in booms and low and falling in deflation and depression. Under the real bills doctrine the central bank therefore acts procyclically—i.e., to magnify the cycle by increasing high-powered money in booms and decreasing it in downswings. Thus the doctrine is counterproductive, a destabilizing rather than a stabilizing influence.

This study documents the injuries which application of the real bills doctrine did to the economy in the 1915–1935 period. The book also shows how pervasive belief in real bills was. Governor Strong was among its adherents, though his commitment to the doctrine was less than total. Last, the narrative brings out the intellectual and operational nexus which runs from real bills to (1) the use of interest rates and free reserves as indicators of the thrust of monetary policy and (2) misplaced emphasis on the stock market with too little attention to production and employment.

Belief in real bills is manifested almost immediately after the Reserve banks opened for business. In 1915 Governor Strong stated that, were it not for the fact that they hadn't built up their securities account, the Reserve banks should be selling "for the purpose of correcting undue ease of money rates, which is only too frequently accompanied by unsound expansion and speculation." (See Chapter I, part 2.) But the doctrine caused no great damage until late 1920. Beginning then discount rates were kept high despite growing evidence of severe deflation and depression in order to force member banks to sell Treasury securities purchased during the war, the proceeds to be used to repay the increasingly costly borrowings via the discount window. The misguided belief behind the policy was that the soundness of the credit system required Government debt to be transferred from banks to "real" inventories—individuals, corporations, etc. Bank credit should be "entirely" devoted, as Governor Strong put it, to "the purpose of producing, purchasing, carrying, or marketing goods." (See Chapter IV, part 2.) The attempt to force member banks to repay their borrowings and sell their Government bonds to the public by way of building a sound "real" base for the credit system led, of course, both to unnaturally high interest rates (as banks sold their Governments) and reduced money supply (as borrowed reserves and hence high-powered

money were cut back). High interest rates and reduced money supply were precisely *not* what was needed as the 1920–21 slump emerged. The policy was thus counter-productive to “the purpose of producing, purchasing, carrying or marketing goods.”

The harm done by the real bills doctrine was catastrophic in the period beginning in the spring of 1928. As I noted above, the attempt to curb stock market speculation completely checked the growth of money supply after April, 1928. Thus the fact that speculative loans have no justification in a real bills regime set the stage for the downswing. The catastrophic errors, errors that assured the decline would be catastrophic, followed after 1929 because of the dominance of the real bills doctrine. The present study describes the process well when it summarizes: “a majority of Reserve officials, including now a bemused Secretary Mellon reverted to the old ‘needs of trade’ doctrine which held that policy should be adapted to current cyclical conditions. *What this meant in 1930 was that the System contracted credit as business declined.* This set off a further decline in business, followed by a further contraction of credit and so on. Little or no effort was made to halt the deflationary spiral—to stimulate an expansion, as Governor Strong would perhaps have suggested, by actively buying securities in the open market.” (See Introduction to Part II). And later, the author observes, “Because the needs of trade were down and declining the emphasis of monetary policy was on liquidation. . . . to reserve officials it seemed merely a matter of safety, of protecting the banking system from making illiquid unsound loans.” (See Chapter X, Part 1). Neither the banking system nor the economy was protected. The real bills doctrine, by requiring the flow of credit and the volume of money to adapt to swings in business activity rather than to lean into such swings, thus worked to magnify the business decline that began in August, 1929, and to leave the banking system and the economy in ruins within four years.

Today it is widely believed that the Federal Reserve is no longer under the influence of the real bills doctrine. But reading this study gives one pause. There is an unnerving similarity between the operating rule for central banks, which operate under the real bills doctrine and central banks using, as the Fed now does, interest rates and free reserves as the target or indicator of monetary policy.

In periods of declining economic activity, to make the point, the real bills doctrine calls for doing nothing. But use of either interest rates or free reserves as the target or indicator of policy may easily lead to inaction in recessions, for rates are low and falling (and free reserves high and rising) in such periods. As Dr. Miller observed in 1930, and as quoted above, “you may be misled into a false sense of the soundness of the general money situation because rates are low.” All too often in recent years we have experienced periods when Federal Reserve officials have been misled into believing they have done whatever they could to reverse a downswing by low interest rates and high free reserves, and periods when they have been misled into thinking they have done what they could to stop ongoing inflation because of prevailing high interest rates and low free reserves. And believing these things, they have delayed taking the actions required to achieve minimal inflation and unemployment. The banker tradition simply does not serve the nation well in the formation and execution of monetary policy.

In summary, the subject of this study is now history. Nevertheless the book is timely. For monetary policy continues to play a crucial role in the performance of our economy and the forces and ideas that shape monetary policy today are much the same as those that magnified the terrible inflation-deflation cycle of 1917-1921, generated a false sense of security by happy accident in the middle twenties, and then set the stage for and greatly aggravated the catastrophic collapse which began in 1929 and dominated history long after 1935. We have much to learn from this book.

ROBERT WEINTRAUB,  
*University of California,  
 Santa Barbara,  
 December 1971.*

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NOTE.—The Honorable Ben B. Blackburn has offered the following observations:

“It is important to remember that the study deals with an historical period—1915-1935, and this span in our Nation’s history provides no basis for attempting a critical appraisal of how the Federal Reserve runs today. Nevertheless, the introduction by Robert Weintraub says the Fed today uses interest rates and free reserves as monetary targets, and is therefore susceptible to the mistake of allowing the money supply to drop during a recession. The record clearly shows, to the contrary, that the Fed over the past two years has sought to gradually increase the money supply.

“There is an assumption in Weintraub’s introduction, and again in the summary (p. 151), that the System is run by bankers selected by bankers. This is not true. No member of the Board of Governors is a banker, and only three of the 12 presidents of Reserve Banks are former bankers. The assertion that key officials are selected by bankers ignores the fact that all Board members are appointed by the President and confirmed by the Senate. It also ignores the role that the Board plays in the selection of the Bank presidents.”

**PART I**  
**EVOLUTION OF THE LOCUS OF POWER AND THE**  
**METHODS AND BASES OF POLICY: 1915-23**

**CHAPTER I**

THE PREWAR YEARS: 1915-16

*1. Organization of the Federal Reserve System and the impetus toward centralization*

The Federal Reserve System consists of three basic elements: the Board of Governors, 12 district Reserve Banks, and several thousand member banks. Under the 1913 Act, the Board consisted of five members appointed by the President for 10 years, one term expiring every two years, and the Secretary of the Treasury and Comptroller of the Currency as ex officio members. The Board was thus a wholly public body under the 1913 Act. The Reserve Banks were not. The Act provided that the affairs of each Reserve Bank would be administered by a nine-man board of directors, six of whom were elected by member banks. Furthermore, under the 1913 Act, each of the twelve regional Reserve Banks was given powers as follows:

(1) "To buy and sell . . . bonds and notes of the United States, and bills, notes, revenue bonds . . . issued . . . by any State, county . . .

(2) "To purchase from member banks and to sell . . . bills of exchange arising out of commercial transactions . . .

(3) "To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount . . ."

During the formative years of the Federal Reserve System, before the United States entered World War I, the regional Federal Reserve Banks maintained a considerable degree of independence from the Federal Reserve Board, insisting on the division of powers which had been provided, but somewhat oblivious to other principles embodied in the act. As the records of the period reveal, an important administrative entity came into being—the Conference of Governors of the Federal Reserve banks—which rivaled the Federal Reserve Board in its power to control the operation of the System. Neither the Conference of Governors nor the office of Reserve Bank Governor itself had been prescribed by the Federal Reserve Act, but both quickly assumed an importance which has been significant in defining the structure and function of the System to the present day.

The governors of the Federal Reserve banks were appointed by their respective boards of directors to be the chief executive officers of the banks, answerable to their directors rather than to the Federal Reserve Board. Commercial bankers by training, the governors reflected the views of the financial community which had favored the creation of a central bank independent of the Treasury or of government policy. As it had emerged from Congress, the Federal Re-

serve System reflected that plank of the Democratic Platform of 1912 which declared its opposition to such a central bank. It divided authority and responsibility between the twelve separate regional banks—a majority of the directors of which, as noted, were elected by the member banks—and the Federal Reserve Board.

Although the Board was composed of presidential appointees and administration officials, it was somewhat insulated from direct executive control. Under the enacting legislation, it had been given authority both to supervise the System and to formulate its policies, the intent being to insure governmental control of the System while granting a degree of participation to the banking community. In this respect, the Federal Reserve Act represented the classical American solution to such problems, resembling as it did the Federal system and perhaps subject to the same kinds of tensions.

Less than a year after the inauguration of the Federal Reserve System a major conflict had arisen between the Board and the Reserve bank governors over the question of their respective powers and responsibilities. The conflict was heightened by the problem of defining the role of the System. The governors tended to view the System as essentially a cooperative enterprise for the mutual assistance of bankers and to favor a conservative interpretation of sound banking policy as a guide for their actions. Seldom was public policy in the broader sense an issue in the Conferences of Governors, and even in the area of open market operations—the development of which was the most important contribution of the Governors during this period—the overall emphasis was less on questions of policy than on bureaucratic procedures.

The Board, on the other hand, reflected the views of the majority of Congress and of the Wilson administration which had seen the establishment of the System as necessary to insure economic growth. To accomplish this end, the legislation had been designed to provide a more elastic currency, to insure governmental control of the banking system, and to guarantee reasonable rates of interest for the commercial borrower. Although the latter objective frequently has been forgotten, it provided the initial policy goal for the System as the Board acted to implement the intent of Congress and pressed for lower and more uniform interest rates.<sup>1</sup>

<sup>1</sup> The majority report of the Senate Banking and Currency Committee had stated: "The stabilization of the rate of interest in the United States will be one of the very important functions of the proposed Federal Reserve System" (S. Rep. No. 133, Part 2, 63rd Congress, 1st Session, submitted by Mr. Owen, November 22, 1913; p. 23). In addition, numerous references to the expectation that the System would aid in reducing rates were made during debate on the bill—one of the more characteristic being the remarks of Oscar Underwood, Chairman of the Ways and Means Committee, who stated:

"I congratulate the wisdom of this committee in . . . establishing a Government control of this system that would represent the borrowers of money and enable the people of America to secure the medium of exchange at reasonable rates of interest at all times. I think that is probably the greatest reform that has been worked out in this bill . . . [and] I believe that this board will carefully and safely manage this, not only in the interest of the American people and low interest rates, but also will have the wisdom to see that the great banking interests of the country are properly safeguarded and protected" (*Congressional Record*, 63rd Congress, 2nd Session, Vol. 51, p. 1459).

Subsequently, Secretary William G. McAdoo wrote one of the more succinct presentations of the Federal Reserve Board's position:

"Ample credit resources at reasonable rates are an indispensable factor in the development of a country and in the growth and prosperity of its business and productive enterprises. The primary purpose of the Federal Reserve Act was to so alter and strengthen our banking system that the enlarged credit resources demanded by the needs of business and agricultural enterprise will come almost automatically into existence, and at rates of interest low enough to stimulate, protect, and prosper all kinds of legitimate business, and to bring about ultimately a greater equality of interest rates throughout the country" (*Annual Report of the Secretary of the Treasury for 1915*, p. 12).

The Reserve banks opened for business in November 1914 and when their governors met for their second conference in January 1915, they openly expressed disapproval of the Board's position. Governor George J. Seay of the Federal Reserve Bank of Richmond argued that in his "judgment as a banker . . . something unsound is being attempted in the effort to equalize rates where conditions vary." Benjamin Strong, the governor of the Federal Reserve Bank of New York who rapidly became a dominant power within the System by virtue both of the size of the New York Bank and of his own personal and intellectual gifts, concurred. His remarks on this occasion reveal the inherent hostility of the banking community to a "political" board and define the nature of the conflict which has plagued the System up to the present day :

. . . I am distinctly under the impression, although I admit that the grounds for it are very slight, that the apparent effort that is being made by the Federal Reserve Board to reduce rates is originated by pressure that is brought upon the Board from outside sources . . .

\* \* \* \* \*

I admit that that is conjecture; I have no ground for making that statement other than an instinct, possibly, but it is the one thing that this system must be guarded against, and I would not be ashamed to read whatever statement is made to the Federal Reserve Board in regard to the demand that they be absolutely free from any influence whatever in considering the rates; that it should come from the Governor of the Federal Reserve banks; that their duty is to sit there as a *judicial body* to review what we suggest to them. What we have in fact established at the respective banks is for them to pass upon, and nobody is entitled to go to that board and tell them what they ought to do in suggesting rates to the Federal Reserve banks.<sup>2</sup> (Emphasis supplied.)

Reserve bank rediscount rates ranged from 6 to 6½ per cent during the first few months of operation but dropped to 4 and 4½ per cent for the period February 1915 to August 1916.<sup>3</sup> In line with orthodox theories on central banking as received in that period, these rates were above prevailing market rates, the argument being that member banks should not be able to profit by rediscounting with the Reserve banks at rates lower than they had received on loans. The institution of a penalty rate by a newly established reserve banking system presented a problem, however. The member banks were slow in seeking accommodation from the Reserve banks and the earning position of the latter suffered accordingly. As a result, some Reserve officials argued for lower rediscount rates, but Governor Strong argued that "the consequences . . . (would) simply be a general reduction of interest rates, without any business to speak of to the reserve banks generally." He explained :

. . . Here are seven or eight hundred millions of reserves unused in the hands of the member banks that are being held awaiting use. The banks are not willing to put the money out at the rates that they can get; it is unprofitable for them to do so, and if the federal reserve banks reduce the rates below their present levels, are they not going to reduce the rates on existing loans and force the surplus into use in order that the banks may earn their expenses and dividends?

Governor Seay's comment at this point further illustrates the bias against low interest rates of many Governors during this period :

The evils attendant upon too low a rate are greater than those attendant upon too high a rate.<sup>4</sup>

<sup>2</sup> *Stenographic Record*, Second Conference of Governors, pp. 457-458. Hereafter, references to this source will be noted as follows: *S.R.*, 2nd Conf., pp. 457-458.

<sup>3</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, p. 439.

<sup>4</sup> *S.R.*, 4th Conf., pp. 185-187.

In view of the depressed economic conditions in his region, Governor McCord of the Atlanta Bank disagreed with the majority of his colleagues and consistently pressed for lower discount rates. He found himself very much on the defensive when, in June 1915, he urged: "We want to serve the general public."<sup>5</sup> In a somewhat acrimonious debate with Governor Strong, he was silenced by an argument which reflected more concern for the needs of the banking system than for those of the public at large.

Governor Strong's argument for maintaining discount rates at levels which were substantially above bank rates in some regions<sup>6</sup> involved the requirement of the Federal Reserve Act that member banks transfer to their district Federal Reserve banks or to their own vaults the deposit balances which they counted as reserves at their correspondent banks so that these balances could no longer be used in making loans. This arrangement for counting deposits at corresponding banks as reserves had been widely criticized in the period following the panic of 1907 as a major weakness in the banking system and was considered a key target for reform. But the requirement of the Federal Reserve Act that reserves be held in vaults or at Federal Reserve banks and hence not be employed in loans for profit had not been popular with the banking community. A compromise provision was enacted which extended from 6 months to 3 years the time during which the banks might transfer their reserves to their own vaults or to the Federal Reserve banks. Governor Strong argued that this arrangement for a more gradual withdrawal of these balances would be endangered if the discount rates were lowered. It would become more profitable for the member banks to borrow from the Reserve banks than from their correspondents, and the result would be a precipitous withdrawal of the \$300 million of correspondent deposits in the New York banks.<sup>7</sup>

These, then, were the two major considerations in the governors' refusal to accept the Federal Reserve Board's policy recommendation that discount rates be lowered. At their Fifth Conference, in the fall of 1915, their disapproval of the Board's position was formally recorded in the Summary sent to the Board. Ignoring the Board's prerogative to interpret the law and the fact that the Conference could have no powers since its existence had no sanction under law, the governors nevertheless voted:

. . . That it is the sense of the Conference that the function of initiating discount rates of all sorts should be exercised by the Federal reserve banks without pressure from the Federal Reserve Board, and that in the opinion of the Conference the various rates heretofore established have been and are at least as low as is compatible with sound banking principles for the reserve banks, in view of the unusual domestic and foreign conditions.<sup>8</sup>

While questions of rate policy and control of the discount rate created the more significant area of conflict between the Federal Re-

<sup>5</sup> *Ibid.*, pp. 277-278: 184.

The discussion includes the following exchange:

The CHAIRMAN (Strong): Governor McCord, you brought up the question of the rediscount rates. What disposition do you wish to make of it?

Governor McCord: I have asked twice to withdraw the proposition. Please understand me. I am not withdrawing it because I am satisfied that you have whipped me in the argument (laughter). I am sorry I brought this discussion up because there is other important business to attend to, and I move that we proceed with the program (*Ibid.*, p. 102).

<sup>6</sup> Although information on interest rates is incomplete for this period, the extent to which the uniform discount rate ignored variations in bank rates in different regions can be gauged by the fact that one brokerage firm offered to buy all of the rediscounts of the Federal Reserve Bank of Dallas at 2¼ percent (*S.R.*, 4th Conf., p. 191).

<sup>7</sup> *S.R.*, 4th Conf., pp. 194-196.

<sup>8</sup> *Summary*, 5th Conf., p. 9.

serve Board and the Governor's Conference, there was another area in which the ubiquitous Governor Strong made an overt effort to usurp Board powers. During the January 1915 Conference he initiated a discussion of the Board's authority to require one Federal Reserve bank to rediscount for another Reserve bank, and remarked that no provision of the Federal Reserve bill had "caused greater concern in New York than the possible delegation to an independent body of the right to take some of the assets of the banks of New York and lend them in some other part of the United States, without the banks of New York having any right to say whether that loan should be made or not." Nevertheless, Governor Strong felt that the intent of the law, to provide a facility for assistance to banks in the South and West during periods of seasonal pressure, could be satisfied if the Reserve bank requiring rediscounting privileges were to apply directly to the Federal Reserve Bank of New York which would, on its own initiative, make a fair rate. He evidently thought that, with a few minor adjustments, the Federal Reserve System could be made to conform to the model suggested in the Aldrich central bank bill which he had helped to write.

. . . I do not believe we need to read the words and letters of the law to determine what we want to do. It may be that some obstacle to a direct procedure of that sort will be found, but I doubt it very much. I do not believe it is the intention of the law to require that there should be a board of seven men acting as a broker between the Federal Reserve banks, and I make the suggestion seriously to you, because I think that that is the sound basis on which this business ought to be conducted.<sup>9</sup>

The Federal Reserve Board had been occupied during this period in formulating the rules and regulations prescribed by law and solving its own problems of organization. Nevertheless, the Board responded to these criticisms and assertions by severely reprimanding the Governors' Conference and curtailing its freedom of action. Appearing before the governors at their January 1916 Conference, the Governor of the Federal Reserve Board, W. P. G. Harding, read a memorandum approved by the Board which noted that "the formation by the governors of a permanent organization . . . may be criticized as of doubtful propriety and beyond the scope of the powers of the Federal Reserve Banks as defined in the Federal Reserve Act." Therefore, the Board had decided that the governors should meet only when called by the Board, that all conferences be held in Washington and that discussions adhere to an outline of topics approved by the Board.

Referring to the action of the Governors' Conference in formally criticizing the Board for suggesting that discount rates be lowered, the Board observed that "the governors of the banks assumed powers which they do not possess under the law when they undertook collectively to direct or to suggest to the Federal Reserve Board the manner of its exercise of the powers conferred upon it by the Act in its dealings with the individual banks." As its memorandum made clear, the Board wished to deal with the Reserve banks as individual banks and would resist any attempt by the banks to delegate powers to a central authority without its approval. Moreover, the Board had no intention of permitting the governors to assume a role in formulating policy. It informed them that their role in advising the Board, "in conference or otherwise," should be confined to "technical questions of op-

<sup>9</sup> *S.R.*, 2nd Conf., pp. 459-463.

eration.”<sup>10</sup> Nevertheless the Governors, led and persuaded by Governor Strong, were instrumental in transforming the Federal Reserve from a decentralized system into a central bank, and a central bank in which they, and especially Governor Strong of the New York Reserve Bank, played an important policy making role. Open market operations were the vehicle for this transformation.

## 2. *The development of open market operations*

The initial impetus for purchases by the Reserve banks in the open market was the need for earnings. It had been intended that the provisions governing open market operations be used to assist in developing an acceptance market and as a means of enforcing the discount rate,<sup>11</sup> and while earnings remained a factor in purchases and sales until after passage of the 1935 Act, Governor Strong was instrumental in educating System officials to view open market operations in their broader context. As early as 1915, he had already suggested a deeper dimension in a speech quoted by the *Wall Street Journal* and included in the Record of the Fourth Conference. Arguing from the deflationary bias which he urged as appropriate to the period, Strong had said:

<sup>10</sup> S.R., 6th Conf., pp. 2-4.

The following is a more detailed excerpt from this interesting memorandum:

“First: Meetings during the first year have been frequent. We believe that, during the current year, there will be little occasion for more than three or four meetings.

“Second: There is no objection to the officers of the respective Federal Reserve Banks meeting informally for conference and discussion of Administrative matters, but the formation by the governors of a permanent organization, the appointment of an Executive Committee, and the election of a paid secretary, are matters that may be criticized as of doubtful propriety and beyond the scope of the powers of the Federal Reserve Act.

“Third: While the Board sees no reason for not approving the expenses for the fiscal year ended December 31, 1915, being a total of \$12,872.02, it would appear that, as a regular item in the expense accounts of the banks, so large an amount might be subject to criticism.

“Fourth: While the Board believes that much good can be accomplished by co-operation in the management of the Federal Reserve Banks . . . and while the Board feels that the conferences of governors undoubtedly have been useful and will be useful in the future in developing best thought as to the technical questions of operations . . . it believes that everything should be avoided that might create the impression that there existed a definite organization which might be considered as extralegal by Congress or by the public at large. While there is no objection to having committees appointed from time to time either by the Federal Reserve Board, or by the Federal Reserve Banks, or by the governors, for the study of particular questions or for preparing upon certain topics, it does appear inadvisable to the Board that a standing Executive Committee should be appointed to represent the governors. It might create the impression that certain banks or certain boards had delegated certain powers to a definite committee . . .”

“Sixth: At the last meeting of the Governors of the Federal Reserve Banks a resolution was adopted in which the Federal Reserve Board was criticized for what was termed ‘an exercise of pressure,’ and the Governors are reminded that the Board is ready at all times to receive representations from the directors of any Federal Reserve Bank, but it considers that the Governors of the banks assumed powers which they do not possess under the law when they undertook collectively to direct or to suggest to the Federal Reserve Board the manner of its exercise of the powers conferred upon it by the Act in its dealings with individual banks. The Board will be glad, from time to time, as in the past, to discuss with the Governors, in conference or otherwise, technical questions of operation, and to have the benefit of the advice of the Governors in such matters in which the Board, not being in touch with the daily and practical operations of the banks, may wisely take the benefit of the experience and information of those in charge of the banks; but the Board must refuse to discuss with the Governors Conference criticisms of its own acts or the manner in which the Board exercises its lawful powers in dealing with individual banks, and in a friendly spirit wishes to impress upon the Governors that proper care should be taken in the future to avoid any topics, the propriety of which on the program of the conference might appear doubtful and would tend to lessen the benefits expected by all from those conferences, and rather harm than help the results to be expected by all from these conferences.”

<sup>11</sup> In his history of the Federal Reserve Act, Carter Glass writes that H. Parker Willis, staff adviser to the House Banking and Currency Committee, drafted the open market provisions for the purpose “. . . of compelling compliance with the reserve bank discount rate and enabling these banks to utilize idle funds in dull seasons in order to earn expenses and acquire a surplus” (*An Adventure in Constructive Finance*; New York, Doubleday, Page and Co., 1927, p. 90).

Robert L. Owen, who drafted the Senate version of the bill, saw the open market provisions as facilitating “. . . the establishment of what is called an open market for bills of exchange and bankers’ acceptances such as has long prevailed in Europe, but which has not existed to any great extent in the United States” (S. Rept. No. 133, Part 2, 63rd Cong., 1st Sess., p. 26).

. . . Had the reserve banks been in operation a few years, and accumulated a considerable loan and investment account their policy under present conditions should be to withdraw funds from the money market for the purpose of correcting undue ease of money rates, which is only too frequently accompanied by unsound expansion and speculation.<sup>12</sup>

Thus, while this period is generally considered embryonic as far as the development of open market operations is concerned, their potential impact was clearly understood by at least one official within the System. Further, Strong was successful in guiding the Governors into actions which constitute an important precedent for the pattern which emerged during the following decade and for procedures for the conduct of open market operations under current law.

At the First Conference of Governors, December 11, 1914, Governor Strong raised the question of the buying price on open market transactions. The Federal Reserve Board had suggested that the Federal Reserve banks establish a rate on a given class of paper, subject to review and determination by the Board, and that that rate prevail for a day or two during which time the bank would take practically everything offered within reasonable limits of the established rate.<sup>13</sup> While Governor Strong did not consider this suggestion appropriate, the reasons for his objections did not become clear until the Third Conference, March 11-13, 1915, when an alternative *modus operandi* was already in the process of development.

Following the Second Conference, the New York Bank had volunteered to make investments and buy acceptances in the New York market for several of the Reserve banks and, briefly, the Boston bank joined in making such purchases as well. The Governors immediately saw the advantage of such an arrangement. Unlike the Board's plan which implied that purchases should be made independently and thus competitively, this procedure avoided the principal defect of competition which would be to "spoil the rate," as Governor Rhoades of Philadelphia put it. Responding to Governor Strong's request for a "uniform and definite policy both as to the methods of handling the (open market) account and . . . as to rates," Governor Aiken of Boston stated the majority opinion:

. . . So far as we are concerned we would like to go on with the present arrangement, and there is one aspect of it that you have not brought out. If we cannot do it, it necessitates our going into the market and buying, ourselves, and that would reduce the rate, unquestionably.<sup>14</sup>

In other words, the Governors felt that sound banking policy dictated the avoidance of actions which would ease money rates downward.

Under the initial arrangement, then, purchases were made in the New York market by the Federal Reserve Bank of New York in response to the earning requirements of the other Federal Reserve banks and so as not to allow rates to bid down. Arrangements for the apportionment of investments on the basis of need were effected during the Fourth Conference, in June 1915, and during the Fifth Conference it was agreed that the New York Bank should be compensated for its services by receiving a certain percentage of the interest on a given class of investment.<sup>15</sup> There were, however, several problems involved.

<sup>12</sup> *S.R.*, 4th Conf., pp. 181-182. It should be noted that this is the only reference throughout the period to the potential impact of sales by the Reserve banks in the open market.

<sup>13</sup> *S.R.*, 1st Conf., p. 3.

<sup>14</sup> *S.R.*, 3rd Conf., pp. 152-154; 158; 160.

<sup>15</sup> *Summary*, 4th Conf., p. 13. *S.R.*, 5th Conf., pp. 178-179, 186, 188-189.

The board of directors of the Federal Reserve Bank of Chicago felt that, with respect to commercial paper and domestic acceptances, purchases by the Reserve banks in the open market "would be in direct competition with our member banks," and had agreed that its policy would be to buy domestic acceptances only from member banks with their endorsement.<sup>16</sup>

Meanwhile, the Federal Reserve Board was aware of the problems of the Reserve banks with respect to earnings and, toward the end of the first year of the System's operation, suggested assessing the member banks to cover expenses. Governor Strong objected that:

In the first place, there is nothing in the Federal Reserve Act that provides for an assessment. It probably would require an amendment to the Act, and the debate on that topic in Congress I believe would open the door to disastrous results.

Governor Strong was probably right in assuming that an assessment would subject the System to considerable criticism. It would not only, as he implied, meet with opposition from the member banks, but would discourage State banks from joining the System.<sup>17</sup>

While this was an effective attack on the Board's position and the proposed amendment was withdrawn, it did not offer an alternative solution to the problem of covering the expenses of the Reserve banks. The Governors were not anxious to raise the issue of open market operations with the Board and while they had agreed among themselves that investments were the solution to earning expenses, they were anxious to preserve freedom of action in this area. As early as the Second Conference, in January 1915, Governors Wold of Minneapolis and Strong had anticipated that the Board would establish an "arbitrary" regulation requiring the endorsement of acceptances purchased by the Reserve banks, as advised by the Federal Advisory Council—the body representative of the member banks—which would limit their discretion.<sup>18</sup> In particular, the Reserve banks were anxious to deal in the acceptances of private bankers and trust companies outside the System, there being a more plentiful supply of this paper than of member bank acceptances. The problem was to find means of obtaining statements of condition acceptable to the Board without prying too deeply into their affairs. "For instance," as Governor Strong noted, "the firm of J. P. Morgan & Company have never made a statement in all their history, even to the Bank of England."<sup>19</sup> But if Morgan and others were to be accommodated with verbal statements, it was necessary both to avoid overt regulation by the Board and to deal with the matter confidentially since the member banks, subjected to more careful scrutiny as a condition of membership in the System, would tend to resent such latitude.

Subsequently the Board did issue regulations requiring a statement of condition in order to make acceptances of private bankers eligible for purchase in the open market.<sup>20</sup> It employed its regulatory powers covering open market transactions to the maximum degree, defining eligibility for member bank acceptances, commercial paper, warrants and Government bonds. Foreign trade acceptances were not covered but were understood to be eligible, while domestic acceptances of State

<sup>16</sup> *S. R.*, 4th Conf., pp. 247–249.

<sup>17</sup> *S. R.*, 5th Conf., pp. 133–134.

<sup>18</sup> *S. R.*, 2nd Conf., pp. 410–412.

<sup>19</sup> *S. R.*, 6th Conf., p. 321.

<sup>20</sup> *Ibid.*, pp. 319–325.

banks which were not members of the System were, in effect, declared ineligible on the grounds that such transactions would not be fair to the member banks.<sup>21</sup>

As for centralization of purchases, the question was raised as to whether the Board had "in any way sanctioned the operation or criticized it." Governor Strong replied:

Well, I do not think they have criticized it in the slightest. They have apparently sanctioned it without formally doing so.<sup>22</sup>

The justification for joint account purchases by the New York Bank was discussed at length during the June 1915 Conference. Governor Strong explained that the New York Bank "let some things go by" in order "not to destroy our market in New York"—not to "mark the rate down on yourself," which suggests that the Reserve banks were thinking of higher rates as advantageous in terms of their own earnings. The New York Bank was, as Strong admitted, competing with the larger New York banks in the market but was careful not to make "an artificial market with our cheap money." In addition, it had made an arrangement with the Deputy Comptroller of the City of New York to buy directly some \$12 or \$15 million of revenue warrants rather than bid for them in the market and drive the rate down.<sup>23</sup> Thus by curtailing competition among themselves through joint investments by the New York Bank, the Reserve banks were able to protect rates and to minimize the effects of competition with the member banks.

Nevertheless, during the October 1915 Conference, Governor Kains of the Federal Reserve Bank of San Francisco expressed reservations about the arrangement.

I feel personally, that I would like to see you discontinue acting as agent for the rest of us. . . . I would like to see all of the banks go into the market. I do not think that the New York bank buys enough . . . and I think you would find it to your interest to let us go in, and the rest of the buyers and fill up our little wants and leave the market open to you all . . . it would be fairer for all the banks to go into the market.<sup>24</sup>

Meanwhile, Governor Strong had adopted a somewhat diffident posture. In a discussion of the question of compensating the New York Bank for its services, he had said:

<sup>21</sup> *S.R.*, 5th Conf., pp. 432-433.

<sup>22</sup> *S.R.*, 4th Conf., pp. 268-269.

<sup>23</sup> *Ibid.*, pp. 260-266.

<sup>24</sup> *S.R.*, 5th Conf., pp. 192-193.

A subsequent discussion of this period, during the April 1920 Conference, indicates that Governor Kains was not the only Reserve bank official who had felt some resentment at the way joint purchases were handled:

Governor MORSS (Boston). . . . As I remember that situation, the Federal Reserve Banks were short on earnings; that is true . . . They were coming into the New York Market through other brokers and competing on the rate with New York, with the New York banks for those acceptances. It was as much for the protection of the New York bank as anything, to protect the rates, and that was a part of that operation.

Mr. KENZEL (New York): It was a question, then, Governor, of stabilization of rates, to prevent them getting too low.

Governor MORSS. That was for the benefit of the New York bank as much as for the benefit of the other banks.

Governor CALKINS. (San Francisco). It was for the benefit of all the banks.

Governor MORSS. Yes, and just as much for New York as for the other banks, to maintain rates, because at that time rates on money were very easy, things were selling very cheap, and competition for those bills would have sent them down to I do not know what price. We bought municipal notes—I was only a director at the bank then—at about two or something per cent.

Governor CALKINS. I think it was one and three quarters per cent.

Governor MORSS. Well, whatever it was, I do not want to be disagreeable about it, but I really think that New York makes rather too much of that argument.

Governor CALKINS. What would the situation be if New York did not buy the acceptances that were offered in the market?

The CHAIRMAN (Chicago). There would not be any market. (*S.R.*, April 1920 Conf., pp. 447-449).

Whatever charge you gentlemen agree is wise will never pay back the New York bank for the work that we have done upon this question. It is a question of how much we are willing to contribute to the welfare of the System by continuing this arrangement. Looking at it from a selfish standpoint, it ought to be discontinued at once.<sup>25</sup>

It was nevertheless clear that Governor Strong wished to protect the arrangement and, given Governor Kains' objections, that more than a verbal agreement was necessary. Subsequently, during the January 1916 Conference, he succeeded in having a resolution adopted which directed the Federal Reserve Bank of New York to prepare figures indicating what minimum investment the bank should maintain to produce income sufficient to cover its current expenses and that the division of investments for other participating banks should take place only after the minimum investment had been made by the New York Bank in its own behalf. This resolution not only accorded *de facto* recognition to the dominant position of the New York Bank, but indirectly sanctioned its role in controlling the volume of purchases.

Another significant aspect of the resolution was its provision for the appointment of a committee to study the question of apportioning investments. Aside from this purely technical function, it was noted that the "object of the committee was to prevent one Federal Reserve Bank from entering into another district and buying securities at a lower rate than was current in that district," and the recommendation of the committee which followed was that any Reserve bank making purchases in another district should do so "only at the rate which the Federal Reserve Bank of that district recommends or would be willing to pay for the investment." Despite the egalitarian appearance of the recommendation and the fact that it was issued by a committee composed of the governors of several banks, it in effect gave control of pricing of System open market transactions to the New York Bank. The committee report makes the point as follows:

Inasmuch as New York City is the chief market in which such investments have in the past been purchased, and since the majority of such purchases have been made by the Federal Reserve Bank of New York upon orders from other Federal Reserve Banks, and inasmuch as New York City is likely to continue the chief market in which such purchases in the future will be made, the committee invited into the discussions the officers of the Federal Reserve Bank of New York, whose interests will be affected in proportion to its very large requirements.<sup>26</sup>

As this resolution indicates, Governor Strong had arrived at the goal of centralizing purchases and sales by means of a series of actions which seemed to have other objectives, a strategy which helped to camouflage the real significance of the achievement. It is not surprising that he was the only official within the System who recognized the importance of Reserve bank transactions in the market since there was no significant market outside New York. Having controlled these operations for the System almost from the beginning, he alone of the governors was in a position to observe their effects on money rates in New York and thus on the country at large.

### 3. *The System's impact on the Government bond market*

The arrangement for centralized purchases was briefly threatened, however, by the way in which the Federal Reserve banks handled purchases of Government bonds. As the following excerpt from the June

<sup>25</sup> *S.R.*, 5th Conf., p. 188.

<sup>26</sup> *S.R.*, 7th Conf., pp. 84-85; 87; 93.

1915 Conference reveals, the governors' concern for earnings led them to ignore the requirement of the Federal Reserve Act that 2 per cent bonds bearing the circulation privilege be purchased at par and accrued interest.

Governor AIKEN (Boston): It seems to me there is only one practical way to do it and that is to have one bank act as agent for the others in making these purchases. As you (Strong) have suggested, the price would go to par at once if we began to buy against one another.

The CHAIRMAN (Strong): It would be worse than that. The price would go to par and be par so hard that we would not be able to get the bonds. As long as they are selling at even a shade under par we always have a market to work on; but if they get right squarely up to par the banks would likely not sell them.<sup>27</sup>

As Governor Strong reported back to the October 1915 Conference, this proved to be an arrangement "which resulted in our being charged with a conspiracy to depress the price of Government bonds."<sup>28</sup> The New York Bank then abandoned its role as agent for the System in making these purchases and concentrated on other types of investments for the joint account. The individual Reserve banks continued to purchase the 2 per cent Government bonds in the open market, however, as required by the Federal Reserve Act for the purpose of retiring the national bank notes secured by these bonds.

A little more than a year later, in a letter to the Federal Reserve Agents dated November 24, 1916, the Federal Reserve Board called attention to the fact that several Federal Reserve banks had recently purchased 2 per cent bonds above par and that the price of the bonds had been driven up by the competitive bidding of the banks. Although the Reserve banks had acted within their legal rights, their purchases had, nevertheless, had the unfortunate effect of creating "an artificial and unnatural market" for these securities which had hindered the Board's efforts to get the national banks to retire their notes.<sup>29</sup> This episode illustrates the critical importance, from the beginning, of Federal Reserve operations in the money market.

The solution which the Board proposed was the appointment of a committee to make purchases of 2 per cent bonds for the joint account of all the Reserve banks to ensure "a more healthy and normal market" for the bonds.<sup>30</sup> The governors were delighted to have their arrangement for joint purchases enlarged and formally approved by the Board and, at Governor Strong's suggestion, added a provision authorizing the committee of governors to establish buying prices and making these prices binding on all Federal Reserve banks.<sup>31</sup> With the addition of these powers, the governors had succeeded in welding together the banks into a single unit—an embryonic central bank. Nevertheless, the majority of Reserve bank officials seem not to have grasped the implications of such a transformation, and continued to view open market operations as primarily a means of assuring adequate earnings. Vice Governor Treman of the New York Bank expressed the position taken by the Governors' Conference in the statement: "We are one unit, and we should help each other to make enough to pay expenses."<sup>32</sup>

<sup>27</sup> *S.R.*, 4th Conf., pp. 349-350.

<sup>28</sup> *S.R.*, 5th Conf., p. 428.

<sup>29</sup> *S.R.*, 9th Conf., pp. 57-58.

<sup>30</sup> *Ibid.*, p. 60.

<sup>31</sup> *Ibid.*, p. 70.

<sup>32</sup> *Ibid.*, p. 37.

Although this constituted the majority view of the function of centralized open market operations, it is clear that Governor Strong saw earnings as only one aspect of these transactions. Given his awareness of their effect on rate levels and the fact that the New York Bank largely controlled the mechanism whose creation it had prompted, it seems reasonable to suggest that the stability of short-term rates in the New York market during 1915-1916 may have been due to the active influence of the New York Bank on that market, and that open market operations may have played an active role in bringing about the lower and more uniform rate levels which the administration and the Federal Reserve Board had announced as the System's objective.<sup>33</sup> In any event, the impetus, organization and theory necessary for transforming the Federal Reserve System into a central bank already existed at the outbreak of World War I. The role of the System in financing the War, however, not only solved temporarily the problem of earning expenses for the Reserve banks, but shifted the focus of the New York Bank as well.

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<sup>33</sup> *Banking and Monetary Statistics*, p. 449. See also footnote 1, above.

## CHAPTER II

### 1917-18: THE ATTEMPT TO FINANCE THE WAR THROUGH NON-BANK INVESTORS

When the United States entered the war on April 2, 1917, the Federal Reserve System had already devised a procedure for centralizing open market operations and controlling the price of Government securities. The war provided a unique opportunity for the further development of open market operations as the Federal debt expanded precipitously from about \$1 billion in 1917—representing primarily the 2 percent bonds securing the national bank circulation—to \$25 billion in 1919. Nevertheless, while the reserve banks were wholly committed to support the price of these new issues, the Reserve bank governors elected to play an indirect role in financing the war, confining their operations to the making of loans to member banks on Government bond collateral and to the administrative functions required as fiscal agents of the Treasury. So rigid was their commitment to this role that, since Reserve bank earnings from discounts rose immediately, operations in the open market virtually ceased.<sup>1</sup>

One factor in the abandonment of open market operations was concern for the possible effects on the System of holding a class of security—the government bond—which could not serve as collateral for currency. On the other hand, the governors were alarmed by the possible consequences of permitting the rapidly expanding Federal debt to carry currency privileges, a legislative proposal considered seriously by the Board.<sup>2</sup> They had, however, favored the amendment enacted September 7, 1916 which permitted notes of member banks, representing 15-day advances by the Reserve banks secured by government bonds, to be used as collateral for Federal Reserve notes. Thus, in this indirect way government securities almost single-handedly financed the immense growth in total Federal reserve credit outstanding—from \$300 million in March, 1917, to \$2,498 million at the end of 1918—while government securities held directly by the Reserve banks during the war never rose above \$330 million, an immense reduction in the percentage of the total Federal debt which they had held at the beginning of the war.<sup>3</sup>

<sup>1</sup> At the April, 1917 Conference, the Committee on Disposition of Government Bonds reported that it had sold \$7,500,000 United States thirty-year conversion 3's for the Reserve banks in January; had ascertained that none of the banks wished the Committee to purchase any United States 2 percent bonds in the open market; and requested further instructions. After some discussion, the Committee was requested to arrange for further sales of about \$2 to \$3 million (*Stenographic Record*, April, 1917 Conference, pp. 19-23). During a subsequent informal conference with the Board, it was reported that the New York Bank had sold \$55 million of bills of exchange to the other Reserve banks, each taking \$5 million (Minutes, November 8, 1917 Conference, p. 1). Meanwhile, the Committee on Disposition of Government Bonds had been voted a continuation of powers and functioned during the war as an agent for sales of Government bonds, maintaining Reserve bank holdings at approximately \$330 million.

<sup>2</sup> *Stenographic Record*, April 1917 Conference, pp. 6-8; 157-158.

<sup>3</sup> RAY B. WESTERFIELD, *Money, Credit and Banking*, New York, The Ronald Press Co., 1947, p. 623. LESTER V. CHANDLER, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, p. 116.

The governors had thought that curtailing their direct holdings of government securities would assure that the Treasury would not absorb a very large part of the credit extended by the Federal Reserve Banks. Their overall objective was to keep the credit resources of the banking system as a whole free for commercial needs by emphasizing private financing of the Government's needs through long-term issues to non-bank investors. They believed that a substantial portion of the "ten or fifteen billions of dollars of savings deposits in (the) country" could be transferred to the Government, affecting the reserves of the banks "to the least possible extent"; that an adequate portion of expenditures could be met from current taxes; and that the amount of investments by banks, representing the short-term needs of the Government, could be kept small.<sup>4</sup> But purchases of wartime Treasury debt issues by commercial banks, though essentially financed by the wartime expansion of Federal Reserve credit, were considered by the Governors to be preferable (less inflationary) to direct purchases by the Federal Reserve banks. Their preferred method of placing wartime Treasury debt issues is not, of course, less inflationary than direct sales to Reserve banks would be. But it is more profitable to commercial banks.

The program which reflected these views was already in the process of development before the declaration of war, the governors having been galvanized into action by a Treasury proposal to sell certificates directly to the Reserve banks. The Treasury had offered \$50 million 2 percent 90-day certificates through the Federal Reserve Board, and had expressed the opinion that "the certificates would be a desirable purchase" since the Reserve banks paid no interest on Treasury deposits while the national banks, normally used as depositories, did.<sup>5</sup>

Governor A. L. Aiken of Boston, acting chairman of the Governors Conference in the absence of Benjamin Strong, replied to this proposal on March 28, 1917, as follows:

We feel that it is of the utmost importance that at the present time the resources of the Reserve banks should be available so far as is possible for the benefit of their member banks; and we should have preferred, had the taking of this issue been burdensome to them, to have rediscounted for them to meet their requirements, rather than to have taken the issue direct, and our committee are in hopes that should future financing of this sort become necessary that it will be dealt with in this way, and the loans placed at a rate that will induce the commercial banks to absorb the issue.<sup>6</sup>

Although Secretary of the Treasury William G. McAdoo and Federal Reserve Board member Paul Warburg vigorously supported the Treasury's proposal that its short-term obligations be taken by the Reserve banks, the governors succeeded in convincing a majority of the Board to accept Governor Aiken's position. Subsequently, an agreement was negotiated between Secretary McAdoo and Governor Strong of the New York Bank whereby short advances, not exceeding twenty days, were made to the Treasury by the New York Bank, with optional participation by the other Federal Reserve banks.<sup>7</sup>

Another aspect of the Treasury's proposal which had caused apprehension among the governors was the question of rates on the new

<sup>4</sup> *S.R.*, April, 1917 Conf., pp. 237: 318-321. Chandler, *op. cit.*, p. 108.

<sup>5</sup> *S.R.*, April, 1917 Conf., p. 283. Chandler, *op. cit.*, pp. 114-115.

<sup>6</sup> Chandler, *op. cit.*, pp. 113-114.

<sup>7</sup> *S.R.*, April, 1917 Conf., pp. 310-312. Chandler, *op. cit.*, p. 115.

issues. They had felt that it was "essential to correct the public mind . . . as to rates of interest which have heretofore prevailed on Government bonds." They argued that there were "special reasons" why a 2 percent rate had been possible before, but that 3½ percent along with a provision for conversion as rates moved upward, would now be necessary "to insure placing (the) issue in the shortest possible time in the hands of the ultimate investor." Governor Aiken warned that "inability to move those bonds promptly at three percent would necessitate a pretty long carry on the part of the member banks, and consequently chronic discounting for a considerable amount at a time when our resources should be as free as possible for the commercial needs of the country."<sup>8</sup>

These views, representing the position of the Governors Conference, were submitted to the Federal Reserve Board as a formal program for war financing and, despite the Treasury's objections to some points, were approved by the Board. One aspect of the program involved a drastic change in the entire fiscal agency apparatus, shifting these functions from the offices of the Independent Treasury System to the Reserve banks. Benjamin Strong and other governors of the larger Reserve banks had long been anxious to have their position as one of the fiscal agents of the Treasury raised to the primary status which they thought was the prerogative of a Reserve banking system. The transfer of these functions to the System did occur during the war years, although it was primarily the New York Bank which assumed the role of fiscal agent since, given its relative size and location in the center of foreign exchange as well as the domestic money market, it was the logical choice as the principal bank of the Government. The Federal Reserve Bank of New York sold and distributed almost half of all securities offered by the Treasury during the war and handled its foreign exchange business and its arrangements with and loans to foreign governments. Its services, and those of the System as a whole, proved so satisfactory that the Independent Treasury System was abolished in 1920.<sup>9</sup>

To resume the main story, a Liberty Loan Committee was organized in each Federal Reserve district along the lines suggested by Governor Aiken and with the governors of the Reserve Banks serving as chairmen. It had been agreed that each issue should receive wide-spread publicity by "first class publicity men," and the first issue, which Governor Aiken suggested should be large in order to capitalize on "the popular enthusiasm and patriotic impulses with which the country is stirred," was quickly sold. To promote sales people were urged to borrow to buy bonds. While it was recognized that this would expand the money supply, the Governors and Board considered this preferable to direct purchases by banks on the puzzling ground that in this way and only in this way would the loans be repaid out of future earnings.<sup>10</sup> Such a method of selling bonds satisfies the requirements of the Puritan ethic but reflects some distortion in understanding of the monetary mechanism. It is certainly no less inflationary than the Treasury's original proposal. Moreover, the amount of public purchases was not

<sup>8</sup> S.R., April, 1917 Conf., pp. 236-238. Excerpt from the memorandum on *Bond Issues*; *Ibid.* pp. 231, 318.

<sup>9</sup> Chandler, *op. cit.*, pp. 104-105.

<sup>10</sup> S.R., April, 1917 Conf., pp. 230, 319.

large enough to absorb the wartime rise of Government debt. Large parts of the wartime debt issues had to be purchased by commercial banks and, in fact banks purchased approximately \$5 billion or 20 percent of the debt issued to finance the war. They did so essentially by borrowing from the Treasury and Federal Reserve banks. Indeed such borrowings also financed commercial bank loans to the nonbank public buyers of wartime Treasury bond issues.

Taking into account that the initial impact of large bond issues sold either to commercial banks or to the nonbank public contract the money supply, the governors' program also provided that subscriptions in amounts over \$1,000 be payable in quarterly installments, and that proceeds be allowed to remain on deposit in the institution receiving the subscription. In effect this permitted banks to "buy" Government securities without liquidating or using other assets in the full amount of their subscriptions. In addition, the program contained two further provisions which have had a profound effect on both the banking system and the Government's debt management policies to the present day. First, Government deposits in commercial banks were exempted from reserve requirements and second, the banks were no longer required to pay interest on Government deposits.<sup>11</sup>

One of the reasons for the suggestion that interest payments on Government deposits be removed was that this feature had led the Treasury to bypass the Reserve banks, which paid no interest, in making deposits and requesting other services as fiscal agents. The more significant reason, however, was to avoid placing "on the depositor bank the necessity of loaning this special deposit to reimburse themselves for interest payments, thereby producing an expansion which is as much to be avoided as is undue contraction in dealing with the situation."<sup>12</sup> The fact, is however, that the banks continued to lend these deposits, now with a substantial increase in income. They were now able to realize the full amount of interest on loans which utilized these free deposits, and also at the same time to collect interest on the Government bonds which they had "bought" in creating the deposits when they subscribed to the Treasury's debt issues. When called on to repay the Government funds deposited, they had only to apply to the Federal Reserve bank for a loan, using the Government bonds which had created the deposits as collateral. The Federal Reserve banks, in turn, were able to use the notes of the applying member banks as collateral for Federal Reserve notes to advance to the bank.

It would be difficult to conceive of a more profitable arrangement for the banks or one which was more inflationary and, by the fall of 1919, it was admitted as such by at least one official within the System, Benjamin Strong.<sup>13</sup> Nevertheless, the arrangement was perpetuated and its use facilitated by the addition in 1932 of a provision permitting Government bonds to be used as collateral for Federal Reserve notes. It is not surprising that the other unusually gifted individual whose career has been associated primarily with the Federal Reserve System, Marriner S. Eccles, saw the very real disadvantages of this arrange-

<sup>11</sup> *Ibid.*, p. 320.

<sup>12</sup> *Ibid.*, p. 321.

<sup>13</sup> *S.R.*, November, 1919 Conf., p. 261.

ment. His proposal that reserve requirements for Government deposits held by commercial banks be reinstated was enacted in 1935 although the no less reasonable proposal to abolish collateral requirements was rejected. Reserve requirements for deposits created by sales of Treasury securities to banks were once again waived in 1943 for the duration of hostilities, and such sales to banks was the primary method used to market these issues during World War II, again proving profitable to banks as well as inflationary to the economy.<sup>14</sup>

Meanwhile, another departure from previous procedures which was to have far-reaching consequences for the System was the introduction of a preferential rate on loans to member banks backed by Government bonds. This provision, devised by Board member Paul Warburg, was a major factor in assuring the success of the Treasury's efforts to borrow so much so quickly.<sup>15</sup> In addition, however, it had the effect of completely undermining the penalty rate theory on which the Federal Reserve System had relied in setting its discount rates, and was a further indication of the extent to which the commercial loan theory had been made obsolete by the amendment which permitted notes on these loans to be used as collateral for currency. The so-called preferential rates were lower than the discount rate on commercial paper and lower than the yield on the Government bond. For the first time, then, the member banks were able to obtain loan accommodation at a profit since the rate on the collateral offered was higher than the rate paid the Reserve bank for the loan. As a result, the preferential rate became, in effect, the discount rate. Discounts of commercial paper ceased to be a factor in applications for Reserve bank funds, while loans by the Reserve banks on Government bonds rose from \$20 million in early 1917 to about \$2 billion at the end of the war.<sup>16</sup>

The result was more of a problem than had been anticipated by the Governors and the Board. The amount of the federal debt itself was more, and the amount of taxes collected less than had been estimated. More of the debt—14 percent of the total—was short-term than had been hoped, and commercial banks owned directly 20 percent—or approximately \$5 billion—of the total. Moreover, the System had made no overt effort to control the growth of total bank credit. Between June, 1916, and June, 1919, total loans and investments of commercial banks increased by \$11,350,000,000, with holdings of Government bonds representing only about half that amount.<sup>17</sup>

As these figures indicate, the System's program for private financing of the war effort through non-bank investors was far from a full success even on its own standard since \$5 billion of the wartime debt issue had to be purchased by commercial banks. Moreover the program had not been able to prevent an inflation of bank credit. The dimensions of

<sup>14</sup> Public Law No. 305, 74th Cong., August 23, 1935. Public Law No. 37, 78th Cong., April 13, 1943.

For a discussion of the proposed abolition of collateral requirements, see *Banking Act of 1935*, Hearings before the House Committee on Banking and Currency on H.R. 3357, 74th Cong., 1st Sess., Feb. 1–April 3, 1935, pp. 196, 219–220.

It should also be noted that, after World War II, Eccles proposed that banks be required temporarily to hold a special reserve consisting of Government securities and/or cash to immobilize new bank reserves created by the System's purchases in support of the Government securities market (Marriner S. Eccles, *Beckoning Frontiers*, New York, Alfred A. Knopf, 1951, pp. 426–429, 473–474).

<sup>15</sup> S.R., April, 1917 Conf., p. 232.

<sup>16</sup> Chandler, *op. cit.*, p. 117.

<sup>17</sup> *Ibid.*, pp. 112, 118.

the problem were relatively slight as compared with other belligerents, but then so was our involvement in the war. Although all the major points of the program had been devised by Reserve officials—including the preferential rate which originated with the Board and the rate on the initial Liberty Loan issue which had been suggested by the governors in consultation with bond dealers—the System took no responsibility for either the program itself or its outcome.

In part, the System's attitude can be explained by the political controversy which inevitably surrounds the Treasury's borrowing programs. As early as the Congressional elections of 1918 the Republican Party made the Liberty Loan campaign an issue. During the subsequent presidential campaign, it charged the incumbent administration with financing the war—

... by a policy of inflation through certificate borrowings from the banks and bonds issued at artificial rates sustained by the low discount rates established by the Federal Reserve Board.<sup>18</sup>

The charge misses a main defect of the wartime finance program which was to permit banks to profit from the program. Inflation is difficult at best to prevent in wartime—virtually impossible unless taxes are raised intolerably high. But although monetary inflation may be unavoidable during wartime, there is no need to pay banks to create the additional money supply as was done in World War I, and again in World War II.

The Federal Reserve System was partly exonerated, however. Generalizing on a later period in its relations with the Treasury—during Secretary Glass' tenure in 1919–1920—Republican critics saw the System as being an unwilling victim of a dominating Secretary and recommended that it “be free from political influence, which is quite as important as its independence of domination by financial combinations.”<sup>19</sup> The argument is moot, especially in a democracy.

Meanwhile, as the greater problems and greater failures of policy in the post-war era emerged, it was perhaps inevitable that System officials would find it convenient to acquiesce to the popular view that their actions had been dictated by the Treasury from the outbreak of war. In retrospect, they appeared to feel that the 3½ to 4¼ percent rates on the four Liberty Loan issues had not been high enough, but overlooked the fact that they had not questioned these rates at the time the issues were floated. Subsequently, Governor Strong alone among Reserve officials was willing to defend the war-time rate policies but, as the following excerpt indicates, he, too, contributed to the long-standing view that the System had played no role in formulating that policy. Appearing before the Joint Commission on Agricultural Inquiry on August 8, 1921, Strong had argued:

Do you suppose for a minute that the United States Government, the Treasury, would permit a loan to fail, in the face of the military necessity of getting the money, because of an interest rate? I believe personally that had we endeavored to force economy—economy of credit and economy in consumption of goods—upon the people of the United States by discount rates, we would have been inviting disaster. There is no limit to the level to which rates would have gone.

<sup>18</sup> *National Party Platforms, 1840–1956*, compiled by Kirk H. Porter and Donald Bruce Johnson, Urbana, Ill., University of Illinois Press, 1956, p. 234.

<sup>19</sup> *Ibid.*, p. 234.

On the question "as to where the final responsibility did rest," Governor Strong added that, under the various Congressional authorizations to borrow money and raise taxes, "responsibility for carrying out the policies of Congress as to the finances of the war . . . rested with the Secretary of the Treasury."<sup>20</sup> But whatever the legal definition of ultimate responsibility, the Federal Reserve, not the Treasury, was the architect of the program of wartime finance in World War I.

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<sup>20</sup> Agricultural Inquiry, Hearings before the Joint Commission on Agricultural Inquiry, 67th Congress, 1st Session, Vol. 2, pp. 453-454.

It should be noted that Secretary William G. McAdoo also contributed to this impression in his book *Crowded Years* (Boston, Houghton Mifflin, 1931), and Elmus R. Wicker (*Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, pp. 8ff.) attributes the policy of war finance primarily to McAdoo. On the other hand, Lester V. Chandler (*op. cit.*, pp. 107-111) makes a case for the fact that Benjamin Strong contributed to devising the program, or at least that some of his ideas on the subject were similar to those finally adopted. The evidence of the Alken memorandum on *Bond Issues* (SR., April, 1917 Conf., pp. 318-321) indicates, however, that the program originated with the Reserve bank governors (probably including Strong) and that the final provisions were worked out in conferences with the governors, the Board and Treasury officials.

## CHAPTER III

POSTWAR ADJUSTMENT: 1919-20

### 1. *The 1920 Fed-Treasury "accord"*

In the early months of 1919, the majority of Reserve officials considered an advance in interest rates both inevitable and desirable. However, war-time controls were still in effect, the peace treaty as yet not signed, and the Treasury needed to float another large loan. This was a potent reason for delaying action, as was the position of member banks, choked with agreements to carry customers on loans on Government bonds until November, 1919. Meanwhile, the action of the British Government in pulling the peg out of the support of foreign exchange had already resulted in an increase in bank rates in New York, and Governor Strong of the Federal Reserve Bank of New York was led "to fear . . . that our liquidation may come a bit too fast for us, and that we may have to take measures to control it; that our problem is almost reversed on our hands over night."<sup>1</sup>

At the March, 1919 Conference of Governors with the Federal Reserve Board, Governor Strong argued that, in theory, an increase in the discount rate on commercial paper would be sound policy—it would impel sales of goods to pay off loans and thus lower commodity prices—but potential losses to member banks on their loans on Government securities made him reluctant to press the point. A majority of the other Reserve bank governors thought of the problem in terms of the need for "a greater commercialization of the system," but opposed an increase in the discount rate. They recommended that the borrowing rate on Government bonds be raised to the level of the commercial rate and that the Treasury should pay 5 percent on the upcoming Victory Loan to compensate member banks for the increase. Under Secretary of the Treasury Leffingwell and several of the Reserve bank governors from agricultural districts countered with the suggestion that, rather than raise the so-called preferential rate on bonds, it might be advisable to reverse the differential, lowering the commercial rate for the time being to encourage bank loans for commercial purposes and stimulate production. None of the arguments were pursued vigorously. It seemed more reasonable to wait for future developments.<sup>2</sup>

At the conclusion of the March Conference, it was agreed that the rate differential should be maintained until after the flotation of the Treasury's fifth loan, that the preferential rate remain uniform for all twelve Reserve banks, and that there be no changes in rates on commercial paper for the time being.<sup>3</sup> By the end of September, however,

<sup>1</sup> *Stenographic Record*, March, 1919 Conference, p. 162.

<sup>2</sup> *Ibid.*, pp. 158, 166, 233-235.

<sup>3</sup> *Ibid.*, pp. 353-354.

As for the suggested 5 percent rate on the Victory Loan, the Treasury declined to accept the advice offered. The rate on the taxable portion of the loan was 4½ percent, and was 3¾ percent on the tax exempt portion. The governors again recommended a 5 percent rate in April, 1920, after the discount rate had been increased to 6 percent.

it was apparent that there had been an escalation in the rate of inflation. Thus, as soon as the member banks were clear of their obligations for the last Liberty Loan issue, the Federal Reserve Board approved discount rate increases for ten of the Reserve banks. Before the increase, rates had been set at 4, 4 $\frac{1}{4}$  and 4 $\frac{1}{2}$  percent. By the end of the year, ten of the banks carried a 4 $\frac{3}{4}$  percent discount rate—New York, the first to increase its rate, having covered the full amount of the increase from its previous rate of 4 percent.<sup>4</sup> The preferential rate was also raised. The difference between the yield on the securities and the rate the member banks paid the Reserve banks to borrow against them was eliminated so that the member banks could no longer profit from these loans. The difference between the rate on loans against Government bond collateral and commercial rates was not eliminated, however, until the latter part of 1921.

The impact on short-term rates in New York City was immediate and dramatic. Between November 1 and November 15, 1919, the yield on 90-day acceptances rose from 4.28 to 4.53 percent, for example. Rates on stock market loans increased more sharply in response to the increase in the discount and preferential rates, the rate on new stock exchange all loans rising from 9.80 to 14.90 percent.<sup>5</sup> But the increases seem hardly to have been noticed within the System. Governor W. P. G. Harding applied pressure for further discount rate increases during the November, 1919 Conference—"regardless of the Treasury situation and of the attitude of the Treasury officials, and despite the attitude of the Federal Advisory Council"—but surprisingly, a majority of the Reserve bank governors opposed a further increase until after the January, 1920 refunding operations. Under Secretary Leffingwell had assured the governors that, after January, "the matter of Federal Reserve Bank rates would be indifferent," and they were content to wait rather than take the risk or accept the responsibility for jeopardizing the Treasury's program.<sup>6</sup>

There were, however, exceptions. Governor Morss of the Boston Bank argued that the Treasury's insistence on a continuation of the preferential rate had endangered the reserve positions of the Federal Reserve banks, while Governor Strong argued that to sell a bond in January at 4 $\frac{1}{4}$  percent and then raise rates would make the System "guilty of a sharp trick." "Either we are emancipated now," he said,

<sup>4</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, p. 439.

<sup>5</sup> See table below :

IMPACT OF DISCOUNT-RATE CHANGES

(*Banking and Monetary Statistics*, p. 452)

	Prevailing rate on—			
	Prime bankers' acceptances, 90 days	Stock exchange time loans, 90 days	Average rate on stock exchange call loans	
			New	Renewal
Week ending—				
Nov. 1.....	4.28	6.00	9.80	7.20
Nov. 15.....	4.53	6.50	14.90	14.00
Increase:				
Absolute.....	.25	.50	5.10	6.80
Percentage.....	6	8	52	94

<sup>6</sup> *S.R.*, November, 1919, *Conf.*, pp. 16–17, 234.

"or else we are not." Governor Harding agreed, noting that an increase in the rates would depress the price of bonds as much in March as in November. "If the Treasury is concerned with the price of Liberty Bonds," he continued, "it seems to me that is something that is going to continue to hang over us."<sup>7</sup>

Unfortunately, following the September, 1919 refunding operations, the controversy over rates had heated up and, as Governor Strong frankly admitted, had "taken the shape of more or less a personal difference of view between Mr. Leffingwell and myself." The Treasury had reduced its floating indebtedness by \$500,000,000 with the expectation that the funds would be used to pay off loans on Government bonds. The funds released stimulated a further expansion of bank credit and an increase in stock market speculation. The Treasury held the Federal Reserve banks responsible for these developments because they had made no attempt to persuade the member banks to use these funds to effect a contraction arranged by the Treasury to be as painless as possible. Instead, Secretary Glass charged, the member banks had been permitted to expand their loans on stocks.<sup>8</sup>

Replying to these charges, Governor Strong argued that the inflationary effect and the increase in loans on stock was the result of the Treasury's aversion to financing at short intervals. The real problem, he said, was that when the Treasury sold a large volume of securities to the banks, it created a class of deposits which required no reserve. Subsequently when the Treasury used the deposits to finance its purchases, the public's deposits, behind which reserves were required, rose, and when called on to satisfy these requirements, banks applied to the Federal Reserve Banks for loans at the then prevailing low discount rates. At this point, Governor Strong said, it was useless to suggest that a Federal Reserve bank "admonish" its member banks. The loans applied for were not for the purpose of lending on the stock exchange but rather:

... to make good a reserve which is impaired by the withdrawal of a deposit which had been created by a loan. The damage is all done [he continued], and that is exactly what takes place in the certificate of indebtedness transaction. That is why it is attractive, that is why it is inflationary.<sup>9</sup>

Governor Strong noted that the Treasury intended to repeat this type of transaction—refunding \$1.5 billion of securities in January, 1920, with a prior issue of \$400 million in December—and warned that it would have a profoundly inflationary impact unless the preferential and commercial discount rates were raised. As an alternative, he suggested that these rates be raised, that at the same time the rate on Treasuries be increased and also that the Treasury be financed by very short borrowings:

... by taking a profit out of that Government deposit, if you please, and compensating the banks that take the deposits by a higher rate of interest, borrow very much smaller amounts for short periods, and keep this thing rolling on little by little until we get over the difficulty; postpone this whole scheme of refunding and take away the inducement to expansion by the creation of these Government deposits to the very limit, and compensate the banks by paying a better rate.<sup>10</sup>

<sup>7</sup> *Ibid.*, pp. 89–90, 234–235.

<sup>8</sup> *Ibid.*, pp. 73, 277–278, 285.

<sup>9</sup> *Ibid.*, p. 261.

<sup>10</sup> *Ibid.*, pp. 261–262.

While others had argued, despite evidence to the contrary, that a higher interest rate was necessary to sell Treasury certificates, Governor Strong recognized that at the current rate the issues would continue to be an attractive investment for the banks. His reason for suggesting a higher rate on Government issues was, as he said, to compensate the banks for the curtailment of a profitable arrangement. He assumed that protecting the profits of member banks was an integral aspect of Federal Reserve policy and argued that unless the Treasury agreed to pay higher interest on its obligations, the System would not be able to raise its discount rates "in good faith." Furthermore, he argued that the consequences of waiting to raise discount rates until after the Treasury operations were out of the way would be the charge:

. . . from every banker in New York . . . that they have been deceived, that we have made a rate to enable them to buy the certificates and as soon as they bought them we have raised on the rate, making it unprofitable and disastrous to them after the Government deposit is withdrawn.<sup>11</sup>

Governor Strong's recommendation that the Treasury finance its operations by frequent short-term borrowings was somewhat in conflict with his recommendation for higher interest and discount rates inasmuch as short term debt serves as a near-money and hence is more inflationary than long term debt. Thus, resort to short borrowings would tend to counteract the anti-inflationary effects of higher interest and discount rates. Strong's reason for recommending this type of borrowing was to protect banks' profits by preventing large capital losses from being incurred as a result of future interest rate increases.

Despite the vehemence of Governor Strong's views, he agreed to go along with the rest of the System in maintaining the status quo until after the January refunding operations. Meanwhile, the Treasury's support operations had successfully stabilized conditions in the bond market in the aftermath of the November discount rate increases, and its overall position had improved. In the early part of December, Under Secretary Leffingwell indicated that the Treasury would no longer seek to impose its views on the System. On December 30, the Treasury reluctantly agreed to an increase in the preferential rate to  $4\frac{3}{4}$  percent at the New York Bank and made no attempt to influence Board approval of increases in the commercial rate to  $5\frac{1}{2}$  and 5 percent at the Kansas City and Cleveland Banks on January 3 and January 12, respectively.<sup>12</sup>

On January 21, 1920, the Board met to consider applications for rate increases and, in what appeared to be an abrupt about-face to many, Under Secretary Leffingwell proposed that the rate on commercial paper be raised to 6 percent and the rate on Liberty Bonds to  $5\frac{1}{2}$  percent. He suggested, however, that the preferential rate on certificates be left at  $4\frac{3}{4}$  percent. While Secretary Glass' vote of approval for the increases—which went into effect at all 12 banks between January 23 and February 2, 1920—was a disappointment to those who favored discriminatory credit controls (and was a vote he later regretted), it reflected his and Leffingwell's concern for the decline in the gold reserve ratio of the Federal Reserve banks.<sup>13</sup> Glass' response

<sup>11</sup> *Ibid.*, pp. 280, 282.

<sup>12</sup> Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, pp. 42-43; *Banking and Monetary Statistics*, p. 439.

<sup>13</sup> Wicker, *op. cit.*, pp. 43-45.

may also have reflected the psychological effects of the conflict with Governor Strong. Strong's behavior in this confrontation had had considerable impact on other Reserve officials as well. He was vehement and convincing and, in the aftermath of his departure on a leave of absence, this new development seemed to confirm his prescience. In any event, the decline in the gold reserves reduced the reservoir of sympathy for the Treasury and caused Glass and Leffingwell to question their own position. Leffingwell subsequently gave in to the New York Bank on two other issues as well.

As it had indicated to the Federal Reserve Board, the Treasury did not anticipate the need for new financing and by January, 1920, had succeeded in reducing its gross indebtedness by \$1.9 billion. Congressional action on post-war settlements, however, made it necessary to float a new loan in April. The new program which the Treasury submitted to the System bore a remarkable resemblance to the plan Governor Strong had proposed in November except for the fact that it provided for a continuation of the preferential rate on certificates. Adopting Strong's rationale, Under Secretary Leffingwell admitted to the joint conference of governors and Board members that there had been "an expansion of bank credit which might partly have been avoided by the frequent issues," and that, therefore, "the Treasury's inclination is to revert, for the time being, to the moderate size, semi-monthly issue of certificates." The ease with which the Treasury acquiesced on this point is partly due to the fact that Secretary Glass had moved to the Senate. His successor, David Franklin Houston, did not oppose financing at short intervals.<sup>14</sup>

The System endorsed the Treasury's program with a recommendation by the governors that it raise the rate to 5 percent—the same recommendation that had been made a year earlier, in March, 1919. A majority of Reserve officials were uneasy about the continuation of the preferential rate but, on the other hand, were reluctant to press for any further rate increases until the effects of the sharp rise in January became clear.<sup>15</sup> The New York Bank was convinced of the need for higher rates, however, and, as the wholesale price index continued to rise into May, together with rising pressure for anti-inflationary action from Congress and the public at large, the Board and Treasury agreed to approve New York's application. New York applied for a 7 percent rate on commercial paper, 6 percent on Victory Loan obligations and 5½ percent on Treasury certificates. On June 1, 1920, these rate schedules were put into effect at the New York, Chicago and Minneapolis Federal Reserve Banks, Boston following on June 4.

## *2. Rate theory and moral suasion*

After the first Federal Reserve discount rate increases were inaugurated early in November, 1919, Secretary of the Treasury Glass who had voted with the rest of the Board to approve the increases, wrote a letter to Governor Harding stating his reservations concerning the action, and expressing the "hope that the Federal Reserve Board will not allow the Governors of the Federal Reserve Banks to rely wholly or too heavily . . . upon the increase in rates . . ." Arguing that the current experience of all European countries and Japan "supports the

<sup>14</sup> *S.R.*, April, 1920 Conf., pp. 3-5, 8-10.

<sup>15</sup> *Ibid.*, pp. 11-12.

view that discount rates will not suffice in these extraordinary times." Secretary Glass outlined the case for moral suasion, the exercise of "a firm discrimination in making loans to prevent abuse of the facilities of the Federal Reserve System in support of . . . reckless speculation." His description of the current speculative mania and the means by which it was financed is interesting in the light of subsequent events, but the more significant part of the letter is its assault on what Secretary Glass called "the copybook texts" concept of the function of the discount rate.<sup>16</sup>

With a bow in the direction of the accepted theory, Glass wrote that discount rates "should, of course, scientifically be above the commercial rate and not below it." However, he noted that until the "independent resources" of the banks returned to a level which would be sufficient to meet the needs of commerce, industry and the Government, without habitual dependence on the Federal Reserve banks, "the tendency will be, as Reserve bank rates are increased, for the rates to the Government and rates to the commercial borrower to be increased in turn." Therefore:

. . . an important further increase in Federal Reserve Bank rates might have the effect of penalizing and discouraging the borrower for commercial and industrial purposes, thus curtailing production and distribution and increasing the shortage of goods, and consequently the price of them, and thus, in turn, stimulating speculation . . . It might have also a very grave effect upon the Government's finances.<sup>17</sup>

This position is substantially the one which was set forth in the Board's *Annual Report* for 1919. In an unusually urgent and eloquent tone, the *Report* stated that:

<sup>16</sup> *S.R.*, November, 1919 Conf., pp. 4-12.

On the subject of speculation, Secretary Glass wrote:

"Speculation in stocks on the New York Stock Exchange is no more vicious in its effect upon the welfare of the people and upon our credit structure than speculation in cotton or in land or in commodities generally. But the New York Stock Exchange is the greatest single organized user of credit for speculative purposes. It is the organized instrument of a countrywide speculation. I believe that the practice of financing speculative transactions in stocks by loans on call, with daily settlements, is unsound and dangerous to the general welfare. Call money loaned to carry speculative transactions in stocks is only liquid when there is no need. The paper is not self-liquidating and, in the case of an emergency, as, for example, upon the outbreak of the European war, and throughout the period of our participation in the war, such loans are in the mass uncollectible. The use of Liberty Bonds, Victory Notes and Treasury Certificates as collateral for borrowing made by member banks from the Federal Reserve Banks for the purpose of carrying speculative transactions in stocks makes it the right as well as the duty of the Federal Reserve authorities to see to it that the methods of financing such transactions are reformed and reformed immediately.

"Open and notorious manipulation of stocks has been taking place during the period of, say, nine months, since the removal of the control of the Sub-committee on Money of the Liberty Loan Committee. This manipulation, which takes the form of putting up the price first of one stock and then of another, no matter what may be the conditions for the purpose of stimulating interest on the part of the uninitiated public, is, I imagine, contrary to the law of the State of New York and the rules of the New York Stock Exchange. In any event, it needs only vigorous action to put an end to it. (The Federal Reserve Bank of New York in its relation to the Sub-committee on Money of the Liberty Loan Committee, which committee was at all times in touch with the officers of the Stock Exchange, naturally sought the views of the Treasury by reason of the fact that its prime duty concerned the sale of Liberty Bonds. A control now put into effect will be primarily for the conservation of the general credit situation and should therefore be inflated and supervised, not only by the Treasury, but by the Federal Reserve Board." (*Ibid.*, pp. 10-11).

<sup>17</sup> *Ibid.*, pp. 11-12.

Secretary Glass' comments on the current status of eligibility requirements is also interesting. (Given his insights into the significance of the increase in Government obligations for the functioning of a monetary system tied to the commercial loan theory, it is difficult to understand the rationale for his position in 1935). Toward the end of his letter of November 5, 1919 to Governor Harding, he wrote:

"In consequence of the war the Government has issued some \$25,000,000,000 of interest bearing securities which are of prime eligibility. Before the war, when the Government's debt was only \$1,000,000 and that all stored away in strong boxes, the possession of eligible paper was very strong presumptive evidence of the right of a member bank to borrow. Now and for the life of this great war debt the possession of eligible paper will be no evidence at all." (*Ibid.*, p. 12.)

. . . The ultimate test of the functioning of a credit system must be found in what it does to promote and increase the production of goods. True in general, the truth of this observation deserves to be particularly emphasized in the present deranged state of world industry and world trade when production is the crying need of the hour everywhere . . .

that :

The normal and traditional method of credit control has been the discount rate ; its efficacy, however, presupposes normal conditions . . . The conditions that make this traditional control effective do not all exist at the present time . . . The demand for commodities from domestic as well as foreign sources is so far in excess of the supply that the increased cost of credit due to an advance in rates is absorbed in the price, and speculation, anticipating large profits, is not checked by any reasonable advance in rates of interest . . .

and that :

Deflation . . . merely for the sake of deflation and a speedy return to 'normal'—deflation merely for the sake of restoring security values and commodity prices to their prewar levels without regard to other consequences, would be an insensate proceeding in the existing posture of national and world affairs.<sup>18</sup>

Opposed to traditional credit control, the Board had come out in favor of rationing credit. But, the Reserve bank governors, who would be directly responsible for administering such a policy, were divided on the question of its merits. Governor Biggs of St. Louis argued that the recent increase in discount rates had been somewhat effective in promoting liquidation, but agreed with the Board that a further increase would probably raise bank rates higher, since, "if we raise them one quarter they go one half." Governor Seay of Richmond thought that the liquidation which had occurred had not been due to the rate increase but, at least in his district, to the Reserve Bank's "admonitory attitude toward the member banks," and Governor Passmore said he thought loans in his district would have increased if the Philadelphia Bank had not refused to lend to member banks having money on call in New York.<sup>19</sup>

Replying to the proponents of moral suasion, Governor Strong argued that if the better banks heeded the admonitions, the other banks would profit by it; and that if the other Reserve banks refused to lend money to banks having money on call in New York, the burden would tend to fall too heavily on the New York Bank. He criticized moral suasion as divisive, as a mere palliative which would drive the "infection" from one place to another and undermine the unity of the System. Governor Morss of Boston, however, objected to "direct action" on the grounds that, with the war over, the member banks were justified in resenting any interference in their decisions as to "what they do with their money." A spokesman for the conservative view, he favored reliance on a rate policy guided by reserve ratios.<sup>20</sup>

Hoping to resolve these differences of opinion, Governor Strong convened the second session of the November, 1919 Conference as a symposium on the merits of the two methods of control : moral suasion versus further discount rate increases as necessary. He asked the governors to consider in turn whether or not "direct action" as it was also called—persuading the member banks to reduce their borrowings from the Reserve banks—would have the effect of raising interest rates.

<sup>18</sup> *Sixth Annual Report of the Federal Reserve Board, 1919*, pp. 69-73.

<sup>19</sup> *S. R.*, November, 1919 Conf., pp. 65-68, 71-72.

<sup>20</sup> *Ibid.*, pp. 68-73.

While Governor McDougal of Chicago did not understand the question, most of the governors conceded that this form of credit rationing would, in fact, tend to raise rates. They agreed that Governor Strong's position was essentially correct: moral suasion would not lessen demand but, rather, would tend to force banks to bid for funds in the open market or contribute further to the tendency of certain banks to seek funds from sources over which the Reserve banks had no control. Governor Seay argued, however, that it could lessen demand and reduce rates if actually made effective—if direct action were wholeheartedly supported on a system-wide basis. While several governors, including Morss, agreed, the point was made that it was the effectiveness of the technique on bank credit policies which was questionable. It was difficult to get information on the lending activities of the member banks, difficult to control the use to which Treasury deposits were put, and impossible to control or influence loans made by non-member banks.<sup>21</sup>

After much discussion, it became clear that a majority of governors doubted the wisdom of relying on moral suasion, but that progressive rates for banks rediscounting in large amounts would be an acceptable compromise to those governors who opposed further discount rate increases. In February, 1920, after the discount rate had been raised to 6 percent, the Board requested and obtained legislation authorizing progressive rates. The authorization was used by the Kansas City, Dallas, St. Louis and Atlanta Banks, but, since the base rate had already been raised, the higher charges to more needy banks were widely criticized and progressive rates were abandoned.<sup>22</sup>

Meanwhile, these discussions were significant for the light they threw on the System's attitude toward the penalty rate. Most System officials, including Secretary Glass, agreed that Reserve bank rates should be above the market, but the Board recognized that the System was confronted with a situation in which dependence on the Reserve banks made it inevitable that member bank rates would be raised above the discount rate. Governor Strong noted, as had Governor Biggs, that banks were "pegging" their rates in relation to the discount rate, but he considered this an artificial rather than a natural relationship. In his comments on the fact that bank rates were tending to advance above and in relation to the discount rate, Governor Strong made what was for him an astonishing statement in that it appears to reflect "the copybook texts" rather than his usual pragmatic approach to events. During the November, 1919 Conference he said:

I think it is a bad rule to have the rates go up automatically . . . because when you measure the rate of interest allowed on balances in banks by the reserve bank rate, you not only exert an influence upon interest rates in the community, but you exert an influence conversely upon the fixing of the rate of the Reserve Bank, which ought to be free of any such influence.<sup>23</sup>

Most of the governors agreed with Governor Strong and were concerned about the moral implications of banks profiting by the spread between the lower discount rate and higher market rates. They felt that

<sup>21</sup> *Ibid.*, pp. 77-90.

<sup>22</sup> The System's experience with progressive rates was discussed by Governor W. P. G. Harding in testimony before the House Banking and Currency Committee, June 1, 1921 (*Amendment to Abolish Office of Comptroller of the Currency*, Hearings on H.R. 4906, 67th Cong., 1st Sess., pp. 4-5). See also Sen. Doc. No. 291, 67th Cong., 4th Sess., Jan. 18, 1923 (Letter from the Federal Reserve Board transmitting information on progressive rates in response to S. Res. 835 of Dec. 6, 1922).

<sup>23</sup> *S.R.*, November, 1919 Conf., pp. 99-100.

this inverted differential created "a tendency to use credit for improper purposes," and induced "too loose a use of credit." They also noted that it was futile to rely on the discount mechanism for control when individual banks were not borrowing. Meeting with the Board, they argued that it was necessary to close the gap between the discount rate and bank rates and to reinstate the discount rate as a penalty rate—a rate higher than that charged by the member bank, which would have the effect of discouraging applications to the Reserve banks for funds except for emergency or seasonal requirements. The Board was skeptical. Governor Harding asked:

Suppose your discount rate to be advanced to 7 or 8 per cent, would not the banks pass the extra rate along to their customers. Would not they get to bidding against each other for deposits and raise the rate of interest they would offer for deposits?<sup>24</sup>

Going a step further, Adolph Miller dismissed the concept of penalty rates as irrelevant and antiquated. He argued that both the spread between the discount rate and bank rates and the decline in reserve ratios were "of very little consequence," providing that there was a clear understanding as to "what is your standard of determining what rates should be," and how much credit should be used. He also implicitly criticized the governors for conducting an academic discussion of policy without an adequate appraisal of conditions, praising Governor Morss for his analysis of conditions in the Boston District and agreeing with him that the principal problem was an increase in business inventories and in personal consumption. Most of the governors had analyzed the problem in terms of member banks' holdings of Government bonds and the behavior of the stock market. Governor Morss' argument—that a rate increase was necessary to convince business that prices would come down so that they would not continue to expand currently to avoid higher prices in the future—seemed far more relevant to Dr. Miller.<sup>25</sup>

Nevertheless, it was their commitment to the penalty rate doctrine that led many of the governors to favor or accept the January 1920 rate increase to 6 percent. A return to classical concepts offered a refuge from doubt and confusion. The choice of such a response necessitated, however, a certain amount of self-deception. The idea was to move the discount rate to a level above current market rates and permit an adjustment to occur as a result of natural forces in the market. The problem was that such a move could not fail to have an economy-wide impact. Aside from the probability that, as the Board feared, there would be a further increase in bank rates without a substantial liquidation of loans, the governors feared that it might increase the rate of bank failures. Both fears were justified. The discount rate did not return to its pre-war position above bank rates until after the full force of the recession had been felt, in December 1920, and the number of bank failures had surpassed the amount recorded for any year since 1893.<sup>26</sup>

### 3. *Postscript: Views on the System's role and function*

As these discussions indicated, differences of opinion on the function of the System were implicit in the disagreement on the better method

<sup>24</sup> *Ibid.*, pp. 234–236, 240–243, 248–251.

<sup>25</sup> *Ibid.*, pp. 224–225, 234–237, 243–258, 262–272.

<sup>26</sup> *Banking and Monetary Statistics*, pp. 283, 439–440, 463.

of credit control. The governors, who came into the System from positions as private bankers, saw its role as essentially passive and favored rate policies which would act less to control credit than to stabilize the market indirectly by providing accommodation at a penalty. The Board, on the other hand, reflected a political climate which saw the control of credit as a public trust and, therefore, presumed a more active role for the System. Given the structure of the System, the prevailing attitude toward its function depended upon which of the several administrative entities—the Board, the Governors or the Treasury—had the larger voice in System affairs. Before the war, there had been an effort by the governors to usurp the policy-making powers of the Board and Secretary Glass saw that, without the existence of a national crisis to strengthen its hand, the Board might again face such a situation. In his letter of November 5, 1919, he warned:

. . . During the war they have naturally turned for leadership to the Treasury since its operations were the dominating factor in the financial situation. It would, however, be a great misfortune if, now that the Treasury operations are on a diminishing scale, the Governors of the Federal Reserve Banks are allowed to feel that the problems of the future were for them to solve each according to his own best judgment. The need of leadership is no less great, the need of examining the situation from a broad national and international point of view is no less imperative. I look to see the Federal Reserve Board, not critically nor aggressively but patiently and persistently provide this leadership.<sup>27</sup>

This concept of the Board's role, however, was not shared by its Governor, W. P. G. Harding. By training and outlook, he was more closely allied to the Reserve bank governors than to Secretary Glass or his colleagues, Adolph Miller and C. S. Hamlin. His view of the relationship between the various groups within the System was expressed in the following comments on Secretary Glass' letter:

The Federal Reserve Board, of course, will assume the leadership which the law devolves upon it, but in doing so it is going to count upon the close cooperation of the Governors of the Federal Reserve Banks. You are the commanding generals in the financial field and in a sense the Board here is a general staff, and there must be a thorough understanding and spirit of concord and cooperation between us . . . We will endeavor to aid you in any of your local problems, and when it comes to general, national or international questions we expect to ask your counsel and advice in order that we can get the benefit of your views as to them and determine more particularly the effect of the policy of the Board upon conditions in your own district.<sup>28</sup>

Governor Harding had differed with Secretary Glass over matters of policy as well. In November, 1919, his resentment over what he later described as Secretary Glass' "domination" of the Board was voiced in his pressure for further rate increases "regardless . . . of the attitude of the Treasury officials." Harding had opposed the policy of moral suasion initially but came out openly in favor of the effort, as did Miller, after Glass left the Treasury in January, 1920. Nevertheless, his attitude toward the Board's role and the function of the System as a whole did not change. Addressing the Governors at the April, 1920 Conference, he made a final plea for a continuation of moral suasion and for the use of progressive rates as a back-up measure. To soften the activist connotations of such a policy, he compared it to accepted practices in commercial banking and characterized it as an effort to return "to a point where the methods that you have been more accus-

<sup>27</sup> *S. R.*, November, 1919 Conf., p. 12.

<sup>28</sup> *Ibid.*, pp. 12-18.

tomed to in your old banking relations must be brought into play"; as a means to release the System from the effects of wartime controls and conditions which were "not commercial banking." Implicit in his remarks was the view that the System should assume a more passive function: "exercising a legitimate and proper control over your credit situation, (and) maintaining your reserves to a point where they should be maintained."<sup>29</sup>

Seizing on the word "control," Dr. Miller offered an alternative interpretation of both its meaning in that context and of the role of the Federal Reserve System. He noted that: "Our Reserve Banking System is the only considerable banking system in the world in which there is no definitely fixed limit of any kind upon the operations of the system"; that reserve requirements, the only factor affecting System operations which is covered by statutory limitation, "can be suspended by vote of the Federal Reserve Board"; that, "when you analyze the thing fundamentally, the discretion of the Federal Reserve Board ultimately is the regulating principle of our Federal Reserve System"; that "it requires virtually parliamentary sanction in England to do what the Federal Reserve Board was set up to do in this country"; that "there is no governmental body in the world, certainly none that concerns itself with banking and finance, that begins to have anything like the powers that the Federal Reserve Board has under the Federal Reserve System"; and that, "in brief, ours is a reserve system by discretion instead of by any fixed principle." Nevertheless, these enormous powers should not be restricted, Dr. Miller added. On the contrary, "I think the Board should exercise its power to restrict . . ."<sup>30</sup>

This exchange of views represents the second round in a continuing struggle over the locus of control within the System and the proper interpretation of its objectives and powers. It is significant because these positions defined the ideological conflict which shaped the System's actions during both the 1920's and the early 1930's and served as the context for revisions of the Federal Reserve legislation in 1933 and 1935; and because, fifty years later, the outcome of this struggle is by no means clear. There are today, as in 1920, those who believe that the System is a passive force and can only act to accommodate the public's demands for money and credit; others who believe the System must be active, lean into the winds, and hence have full discretion, constrained neither by a fixed principle or rule or Presidential guidance; and there also are many who believe that the monetary authorities must be guided either by a principle embodied in law or by the President, who is, after all, responsible for the performance of the economy in-the-large.

<sup>29</sup> S.R., April, 1920 Conf., pp. 512-516.

<sup>30</sup> *Ibid.*, pp. 519, 526-528, 535-537.

## CHAPTER IV

### THE DEPRESSION OF 1920-21

1. "We must have a definite policy" (Governor Harding, January 6, 1920)<sup>1</sup>

The April, 1920 Conference of Governors of the Federal Reserve Banks ended on a pessimistic note. Drafting their summary for the Board, the governors wrote that "the increase of rates, coupled with the moral suasion generally employed by all reserve banks, had acted as a restraining influence upon expansion which undoubtedly would have been greater but for this action"; but they saw, as yet, no conclusive evidence that the 6% discount rate inaugurated in January would force liquidations and reduce prices. They agreed:

... that the discount rate is nevertheless a most effective method of controlling expansion, and it was the general opinion that the increases of rates already made had not yet had time to become fully effective.<sup>2</sup>

Even so, most System officials were uneasy about the continued rise in the wholesale price index, and the New York Bank had already indicated that it thought a further rate increase would be necessary.

On May 17, the Senate passed a resolution requesting that the Board prepare a statement on how it proposed to meet the current inflationary trend and mobilize credit to move the 1920 crops. During debate on the resolution, the Republican majority indicated that they favored a further rate increase. The minority, composed of Democrats and Progressive Republicans, argued that the rate increases already inaugurated had merely contributed to an increase in prices and were ruining the farmer. Senator Robert L. Owen, co-author of the Federal Reserve Act, warned that the current deflationary policy "is going to lead to an industrial depression"; that it could only "bring down prices by creating a depression instead of bringing down prices by creating a new volume of commodities." The chairman of the Senate Banking and Currency Committee, George P. McLean of Connecticut, replied that if the objective is to reduce prices, "the normal way is to raise the discount rate." He ignored the fact that this would adversely effect production and employment.<sup>3</sup>

Meanwhile, the Federal Reserve Board had scheduled a conference on May 18, 1920, with those officials within the System who were also private bankers—the 12-man Federal Advisory Council and the 3 Class A directors of each of the Reserve Banks. The chairman of the House Banking and Currency Committee, Edmund Platt of New York, who was subsequently appointed vice-governor of the Board, was also present, as was a representative of the American Bankers'

<sup>1</sup> *Federal Reserve Bulletin*, February, 1920, p. 117.

<sup>2</sup> *Summary*, April, 1920 Conf., p. 2.

<sup>3</sup> *Congressional Record*, 68th Cong., 2nd Sess., Vol. 59, pp. 7039, 7145-7146, 7202-7203, 7563, 7975-7977.

Association. Governor Harding announced as the rationale for this unusual conference that it seemed "peculiarly appropriate, at a time when there is a banking situation to discuss, to have bankers here to discuss it." A more accurate explanation would have been that the Board was about to make a declaration of operational bankruptcy and had decided to pass the burden for credit control to the member banks.

Governor Harding opened the conference with the following statement of economic conditions:

It is this tendency of production to decline, particularly in some essential lines, which constitutes a very unsatisfactory element in the present outlook. It is evident that the country cannot continue to advance prices and wages, to curtail production, to expand credits and to attempt to enrich itself by non-productive and uneconomic operations without fostering discontent and radicalism, and that such a course, if persisted in, will eventually bring on a real crisis.<sup>4</sup>

Much as in 1970-71, growing evidence that production had fallen off in spite of continuing inflationary pressure was a major source of concern. Senator Owen had argued that it was due to the increase in rates in January, and that a rollback in rates was necessary to stimulate production and bring down prices. He suggested a discount rate of 3 percent coupled with a rigorous policy of moral suasion.<sup>5</sup> Those who favored a continuation of high rates tended to agree with the Federal Advisory Council that the decline in production was due to strikes and other problems with transportation and to the "inefficiency and indifference of labor." Governor Harding added that it was also due to a "world-wide lack of capital," but, referring to Owen's position, argued that "however desirable on general principles continued expansion of trade and industry may be, such developments must accommodate themselves to the actual supply of capital and credit available."<sup>6</sup>

The Federal Reserve Board had attempted to encompass both views in formulating its position. As explained by Governor Harding, it favored a policy which would "restrict credit and expand production, letting the expansion of production proceed at a greater rate than the reduction of credit." This could be accomplished by "a sensible and gradual liquidation"; "any attempt at radical or drastic deflation merely for the sake of deflation . . . should be avoided." However, the successful execution of a policy of gradual liquidation could not be administered by the Board. The allocation of credit should be handled primarily by the member banks themselves. The member bank must be gently weaned from its dependence on Federal Reserve funds

<sup>4</sup> *Minutes*, May 18, 1920 Conf., pp. 2-3.

These Minutes were subsequently printed by Senators Robert F. Owen and Carter Glass—as Sen. Doc. No. 310, 67th Cong., 4th Sess., Feb. 24, 1923—as an exhibit in the context of their criticism of the System's actions during this period. Earlier John Skelton Williams, Comptroller of the Currency in the Wilson administration who had been present at the Conference, had told the Joint Commission of Agricultural Inquiry that there had been a deliberate conspiracy to bring on a depression.

<sup>5</sup> *Cong. Record*, 66th Cong., 2nd Sess., Vol. 59, pp. 7039, 7202-7203.

There are interesting similarities between Senator Owen's position and that of the Council of Economic Advisers during a subsequent period of inflationary pressure. In November 1950, the Council told the Joint Committee on the Economic Report that "an important inflationary movement should be met by increasing the facilities and volume of production. This process requires cheap and ample credit, and until the volume of output increases, inflationary pressure will increase and must be curbed by other than monetary measures of the kind which increase the cost of capital" (statement of John D. Clark, former member of the CEA; *United States Monetary Policy*, Hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, 83rd Cong., 2nd Sess., December 1964, p. 48).

<sup>6</sup> Recommendations of the Federal Advisory Council, May 10, 1920. *Summary*, April, 1920 Conf., p. 2. *Minutes*, May 18, 1920 Conf., pp. 3, 5, 14.

and the individual banker must learn to "expand his business . . . more and more out of his own resources", exercising "a wiser discretion in the matter of granting credit."<sup>7</sup>

On the question of discrimination in lending there was a division of opinion within the Board as well as between the Board and the financial community. Many of the Class A directors present at the conference expressed relief that the Board was not proposing "to classify loans into essentials and nonessentials". That, however, was what several Board members advocated. Dr. Adolph Miller summed up their position:

. . . Eventually, it is the user of credit that has got to be brought into a more or less responsive and acquiescent attitude in this policy of control. There is no use attempting to evade the fact that control, if it is anything more than a process of self-deception, means actual control; that somebody has got to go without the credit he thinks he is entitled to or the credit he would like to get. But it would, I think, be a mistake to treat this simply as a quantitative problem instead of, as I think it is primarily, a qualitative one. I would not be at all alarmed at the growth of credit in this country if we had the assurance that credit was only going to the users of credit contributing to the production of those things the country badly needs at the present juncture.<sup>8</sup>

Apart from the directors of the Federal Reserve Bank of New York, most of the members of the conference were not opposed to the concept of moral suasion and a few favored progressive rates. It was thought that the System's admonitions had been effective in restricting the amount of bank credit used to finance the stock market despite inherent difficulties in ascertaining how credit was used. They were unwilling, however, to endorse a program in which loans to producers and distributors of such luxury items as automobiles would be declared ineligible when the paper itself met all the requirements of eligibility. Although it was recognized that an emphasis on quantitative control would penalize smaller producers and farmers, most of the officials present at the conference favored continuing current policies. The view of the majority was summed up by E. S. Kennard, a director of the Boston Bank:

I also think that the rates for money should continue on a high level with the hope of causing liquidation in commodities. Of course, liquidation would result in low prices and the easing up of business. I do not think this body should encourage any drastic measures of readjustment. I think the deflation should be gradual, and I think we should give more care to the commercial paper that is rediscounted at the Federal reserve banks.<sup>9</sup>

The more significant debate centered on the proposal made by the New York directors to raise the discount rate to 7%. The possibility that it might have drastic consequences was noted immediately:

Governor HARDING. May I ask if that raise of rate would penalize anybody who could not liquidate on account of lack of transportation facilities, or would it encourage the liquidation and distribution of goods?

Mr. ALEXANDER. Well, I am afraid somebody is bound to be penalized in order to bring about production. A percentage of 1 per cent is not a very heavy penalty in the way of an interest charge, but it is a very positive announcement that the credit situation is such that further expansion must be prevented and that curtailment should be had wherever possible.

I do not think we need to consider that question unduly, Governor Harding, any more than we need to unduly consider the position of these people who bought Government bonds and who have seen them fall to 85.<sup>10</sup>

<sup>7</sup> *Minutes*, May 18, 1920 Conf., pp. 5-8.

<sup>8</sup> *Ibid.*, pp. 39, 47-48.

<sup>9</sup> *Ibid.*, p. 12.

<sup>10</sup> *Ibid.*, p. 14.

Only a few of the officials present at the conference endorsed the proposed increase to 7% and a few were emphatically opposed. The majority indicated a reluctance to take such action, although they did not say why. No one suggested that an increase would put the discount rate above the market. Rather, most participants acknowledged that the rate to the borrower would be increased except in those States that had a statutory ceiling and that there, the pressure on member banks would be insupportable.<sup>11</sup>

Meanwhile, Governor Harding delegated the task of drafting a reply to the Senate resolution to a committee composed of the Class A directors of the Boston, New York and Philadelphia Reserve Banks, the chairman of the board of the San Francisco Bank, and James B. Forgan of Chicago, who was present at the conference in the dual capacity of president of the Federal Advisory Council and representative of the American Bankers Association. Governor Harding was asked to serve as chairman of the committee but replied that he did not want to be a member. A director of the Minneapolis Bank, E. W. Decker, protested that "it is conferring rather broad powers to put into the hands of the committee a commitment of this whole conference on perhaps the most important matter of all," and, at his insistence, Governor Harding agreed to sit with the committee in an *ex officio* capacity.<sup>12</sup>

The resolution drafted by the committee and sent to the Senate on May 25, 1920, made the following argument:

The whole country is suffering from inflation of prices with the consequent inflation of credit. From reports made by the members of this conference, representing every section of the country, it is obvious that great sums are tied up in products which if marketed would relieve necessity, tend to reduce the price level, and relieve the strain on our credit system.

Elaborating on this point in the accompanying letter, Governor Harding noted that the discount rate increases put into effect in January "have not been entirely effective in bringing about the reduction in loans desired," and that the normal volume of liquidation during the early months of the year had not occurred because of the tie-up of transportation. He reiterated, however, that as soon as goods could be moved and sold, loans would be liquidated. Thus, the "more vital problems relating to the movement of the 1920 crop are physical rather than financial." Accordingly, the committee resolved to send a delegation to the Interstate Commerce Commission and the United States Shipping Board to discuss means to provide the transportation facilities necessary to solve the problem.<sup>13</sup>

Several days later, Governor Harding's reply to a letter from Senator Owen was made public. The Governor suggested that the Senator was "disposed . . . to ignore the fundamental law of supply and demand", and that if the System were to establish the stable low rates proposed by Owen, the result would be a "wild scramble for discount accommodations," followed by an "enforced denial of all credit" as the System reached the limit of its available resources. Although Harding had stated earlier that the rate increases of January had been somewhat effective in checking expansion, he did not acknowledge that

<sup>11</sup> *Ibid.*, pp. 18-31, 35-39.

<sup>12</sup> *Ibid.*, pp. 44-45.

<sup>13</sup> *Federal Reserve Bulletin*, June, 1920, pp. 582-584.

they represented an active effort to implement a policy objective—i.e., to control the demand for credit. His statement suggested that, on the contrary, changes in the level of discount rates should not represent an attempt to influence financial conditions, but, rather, to reflect them:

The Federal Reserve Board does not take the view that discount rates should be arbitrarily fixed by it; it recognizes the fact that there are certain basic conditions which affect the demand for and the supply of credit throughout this country and throughout the world, and that the formal establishment of a rate is merely an interpretation of these conditions.<sup>14</sup>

This statement was made on the eve of a rate increase at the New York and three other Reserve Banks to the historic level of 7%. In light of the fact that the probable effects of this action had been anticipated, Harding's statement appears as an advance disclaimer of responsibility for those effects. It announced as the official position of the Board that the role of the System was an essentially passive one; that credit policies were, ultimately, the responsibility of the member banks; and that the function of the Board was to adopt a posture of prudent response. The argument was familiar but the theoretical framework had been dismissed as outmoded, only a few months earlier, in the Board's *Annual Report*. As Dr. Miller acknowledged subsequently, the Board took refuge in theory because it had no policy.<sup>15</sup>

## 2. *The behavior of interest rates and prices*

The Federal Reserve Bank of New York had applied for an increase to 7% on commercial paper, 6% on Victory Loan obligations, and 5½% on Treasury certificates. On June 1, 1920, these rates schedules were put into effect at the New York, Chicago, and Minneapolis Reserve Banks, and at the Boston Bank on June 4. The Atlanta Bank raised its rate to 7% on November 1, 1920, and on February 15, 1921, the Dallas Bank also adopted the higher levels. There were no further rate changes until April, 1921, the other six Federal Reserve banks having retained the 6% rate.<sup>16</sup> Thus in less than eight months, beginning in November, 1919, the discount rate had been increased from 4 to 7 percent at the New York Bank. Deflation and depression followed.

In its *Annual Report*, the Federal Reserve Board recorded a drop in wholesale prices of 20% between May and October, 1920. By the end of the year, there was a further overall price decline of 10%. The *Annual Report* for 1921 noted a further decline of 26% for that year, or an overall price decline of 56% for the 18-month period. Some industries were hit harder than others. The price of cotton had dropped 93%, oil prices were down 50% and the price of cottonseed oil was down 80%. It was reported that there was "pretty complete stagnation" in the lumber industry, and that agriculture in general

<sup>14</sup> *Cong. Record*, 66th Cong., 2nd Sess., Vol. 59, p. 7563.

<sup>15</sup> *Sixth Annual Report of the Federal Reserve Board*, 1919, pp. 69-73.

Dr. Miller's comments on this period were made during the May, 1928 hearings on stabilization. He described "the Federal Reserve mind" as "perplexed," and "in a state of mental confusion," and added:

"... one of the chief troubles with the Federal reserve system in 1920 was hysteria—hysteria in part due to the interference of Congress through a Senate resolution, with the maintenance of a well-balanced frame of mind in the Federal reserve system" (*Stabilization*, Hearings before the House Committee on Banking and Currency on H.R. 11806, 70th Cong., 1st Sess., pp. 162-163).

<sup>16</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, pp. 439-440.

had suffered a disastrous blow. Business also was hit hard, particularly in New England. The 1921 *Report* noted a total decline of 31% in the volume of business and a total decline of 42% in the volume of manufacturing.<sup>17</sup> Moreover, there was a staggering five-fold increase in unemployment to 11.9% during the year 1921, or an increase of 4 million in absolute numbers.<sup>18</sup>

The 1920–21 “slump”, as it was called, is notable in economic history for several reasons—first, for the remarkable rapidity with which prices fell and for the amount of shrinkage in the price level. Another unusual aspect of this recession is the fact that interest rates remained stable despite the vertical fall in prices. The level of short-term open market rates remained above 7% from May, 1920 to May, 1921, while the average bank rate on customers’ loans was 6% from January, 1920 to January, 1922. The depression was, therefore, unique in that all prices fell except the price of money.<sup>19</sup> The failure of interest rates to fall as prices fell would appear to reflect in part the fact that expectations in credit markets were still dominated as much by the wartime inflation (which continued to May, 1920) as by the ongoing deflation—i.e., that expectations are formed from both current and near-past experience. But the failure also would appear to reflect in part Federal Reserve policy.

The System’s response to these events was within the framework of the penalty rate theory. It ignored the price level which reflected current forces, and focused on interest rates which reflected past forces. Thus, when bank rates in Southern and Western cities rose to an average of 7.10% for January, 1921, the Federal Reserve Board approved an increase in the discount rate at the Dallas Bank to 7%. There had been an overall drop of some 40 to 50% in agricultural commodity prices, and an even sharper decline in the prices of such major local products as cotton, cottonseed oil and petroleum. Nevertheless, rates on customers’ loans by banks in the South and West remained above 7% until September, 1921.<sup>20</sup>

Critics of the System’s policies argued that one would ordinarily expect interest rates to decline in response to such a precipitous break in prices, and that bank rates would have been lowered had not the System maintained its discount rates at such high levels. The System claimed that the maintenance of its discount rate above market rates was sound central banking policy. However, its action with respect to the Dallas Bank rate was not rational even in the context of the penalty rate theory. The most orthodox monetary theorist would not have suggested an increase in rates during such a sharp deflationary spiral. The error was to be repeated in 1931 with even more disastrous consequences.

In 1931 the Federal Reserve erred by ignoring the internal cash drain which was reducing member banks’ liquidity when it raised the discount rate to curb the external gold drain. The 1931 rate rise greatly

<sup>17</sup> *Seventh Annual Report of the Federal Reserve Board, 1920*, pp. 7–9. *Eighth Annual Report of the Federal Reserve Board, 1921*, pp. 10–12. *S.R.*, April, 1921 Conf., pp. 53, 65, 75, 90, 610, 616, 635.

<sup>18</sup> Benjamin M. Anderson “The Road to Full Employment”: *Financing American Prosperity* (Paul T. Homan and Fritz Machlup, eds.), New York, The Twentieth Century Fund, 1945, p. 25. *Historical Statistics, Colonial Times to 1957*, House Doc. No. 33, 86th Cong., 1st Sess., p. 73.

<sup>19</sup> *Banking and Monetary Statistics*, pp. 450, 463.

<sup>20</sup> *Ibid.*, pp. 440, 463.

magnified banks' liquidity problems. In 1920-21 the error was based on a misreading of monetary developments. The problem which confronted Reserve officials beginning in the summer of 1920 was that, despite the break in prices which should have forced liquidations of bank loans, the indebtedness of the member banks to the Reserve banks did not decline significantly until the latter part of 1921. During the latter part of 1920, member bank borrowings were well above \$2.5 billion, and had only dropped to \$2.1 billion by April, 1921. This was interpreted as an indication of continuing inflationary pressure despite the sharp price declines noted earlier, and System officials saw no means other than maintaining high discount rates to force repayments of loans to the Reserve banks.<sup>21</sup>

While the primary focus at this point was on the total volume of bank credit, Reserve officials still worried about the amount of Government debt carried by the banking system. They continued to press for policies which would get the debt into the hands of the "ultimate investor"—that is, transfer the bulk of Government securities held by the banks to individuals, corporations, etc. It was thought that "normal" conditions would return when, as Benjamin Strong described it, the credit facilities of the System were "entirely" devoted to "the purpose of producing, purchasing, carrying, or marketing goods . . ." <sup>22</sup> The experience of 1920-1921 demonstrated, however, that the real bills doctrine was no more viable than the penalty rate. At no time in subsequent years has the banking system succeeded in functioning without the leverage afforded by Government indebtedness as collateral, nor has it attempted to function with discount rates above the level of market rates as in 1920-1921.

Meanwhile, the System's decision to keep its discount rates up was buttressed by what Reserve officials thought were other signs of continuing inflationary pressure—the failure, for instance, of retail prices to drop as sharply as wholesale prices. Governor Strong and Dr. Miller thought wage levels were still too high. Ignoring the alarming rate of increase in unemployment, Dr. Miller remarked in April, 1921 that there could not be "a return to the safe and sound condition of the industries of this country until (there is) what is called liquidation of labor." Admitting that "that phrase (is) a little energetic, or a little offensive," he argued that it should nevertheless be noted that labor organizations were preventing "a revision of wages in accordance with the cost of living," and advised "consideration . . . (of what) we can with propriety do to apply the accelerator to the liquidation in retail markets," as a means of getting at the problem, of getting "things in this country on an even keel." Governor Strong agreed. He adamantly opposed the rate reductions pushed through in April and May by the new Secretary of the Treasury, Andrew Mellon, warning that they "violated sound central banking principles."<sup>23</sup>

By fall, however, the perspective had shifted. One of the participants in the October, 1921 Conference of Federal Reserve Bank Governors—Eugene Meyer, director of the War Finance Corporation—commented:

<sup>21</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1953, p. 169.

<sup>22</sup> *Ibid.*, p. 137.

<sup>23</sup> *S.R.*, April, 1921 Conf., pp. 674-679. Chandler, *op. cit.*, p. 174.

... there is a good deal of impetus still effective from the contraction psychology of collecting and reducing. When you start a wave of contraction—I do not mean when you start it, I mean when a wave of contraction starts—it does not always stop as soon as it might be considered a good thing to have it stop.<sup>24</sup>

The continuing deflationary spiral took its toll on the banks as well as on other segments of the economy, and this was a particular source of embarrassment to the System. The rate of bank failures rose from 62 in 1919 to 167 in 1920 and reached 505 in 1921, a peak which surpassed the previous record of 491 failures in 1893. Nevertheless, many banks were making substantial profits on high interest rates and that, too, was a source of embarrassment to the System. The earnings of the Federal Reserve banks themselves rose to unprecedented levels—a level in October, 1920, which was not attained again until World War II. Thereafter, Reserve bank earnings declined every month during the year 1921, eventually putting pressure on them (in November) to make expenses from earnings on open market purchases.<sup>25</sup>

By the latter part of 1921 the financial situation had improved. The Federal Reserve Bank of Boston had dropped its rate to 6% on April 15, agreeing with Secretary Mellon and other members of the Board that the banks should not be pressed further. The other five banks which had adopted the 7% rate lowered their rates in May—New York, Chicago, Minneapolis and Dallas to 6½%, and Atlanta to 6%. Further reductions followed. Sometime during the summer, the New York Bank had begun buying Treasury certificates in sufficient amounts to support the price at par, and had also acted as agent in funneling \$300 million of foreign funds into domestic acceptances. It had been able to justify a reduction in its buying rate for bills from 5 to 4% on September 23, 1921. The overt indication of a change in policy came in November, with further reductions in discount rates—to 4½% at the Boston, New York and Philadelphia Banks, and to 5 and 5½% at the other Reserve Banks. For the first time in more than a year, the overall level of discount rates fell below the average rate charged by banks on customers' loans.<sup>26</sup>

Lester V. Chandler notes that a large part of the expansion of Federal Reserve credit in 1919 had not been used to increase the volume of member bank reserves, but had been drained out of the banking system to meet an increase in the demand for circulating currency. This fact was overlooked by Reserve officials. Fortunately, the drain did not persist after 1919. If it had, given the System's discount rates, the banking system could easily have collapsed then as it did a decade later in the face of a cash drain and ill-conceived discount rate policy. But the currency drain ended in 1920 and in 1921, as the volume of retail trade and payrolls was deflated, the cash flowed back into the banks and, together with gold inflows, enabled the member banks to reduce their indebtedness to the Reserve banks. The monetary gold stock rose about \$710 million during 1921 and the net inflow of currency into the banks amounted to \$680 million, a total net inflow of \$1,390 million. As a result, the indebtedness of the member banks was reduced by \$1,340 million in 1921.<sup>27</sup>

<sup>24</sup> *S. R.*, October, 1921 Conf., pp. 143-144.

<sup>25</sup> *Banking and Monetary Statistics*, pp. 283, 261, 356.

<sup>26</sup> *Ibid.*, pp. 440, 443, 463.

<sup>27</sup> Chandler, *op. cit.*, pp. 175, 186-187.

In November, 1921, open market operations which were transacted primarily to increase Reserve bank earnings, again played a part in easing money rates and further reducing member bank indebtedness. As earnings on discounts declined, the Reserve banks began making proportionate investments in Government securities. Between November 1921 and May 1922, the System purchased over \$500 million of Government securities. By June, 1922, market conditions justified a further reduction in discount rates to 4 and 4½%, and recovery was well underway.<sup>28</sup>

### 3. *Rate theory and the political repercussions of deflation.*

The causes and cures for inflation had been a major issue in the 1920 presidential campaigns of both political parties. With the sharp break in prices in the fall of 1920, the focus shifted but the Federal Reserve System was again embroiled in controversy over its influence on the American economy. System officials who were called upon to explain their rate policies in terms of economic events managed, however, to evade the issue, describing their actions in theoretical terms and in a purely financial context. On December 7, 1920, the governor of the Board, W. P. G. Harding, addressed a hostile meeting of the American Farm Bureau Federation at Indianapolis and gave the following explanation of the System's position:

Normally the discount rate of a Federal reserve bank should not control the rates at which member banks loan money to their customers. In the countries which have central banks, there is a well-established policy that the central bank discount rate should be maintained at a figure slightly in excess of the current market rate. The wisdom of such a policy is apparent for it eliminates all consideration of profit in rediscount transactions and gives the central bank better control over its own reserves and causes the banks which deal with the public to rely to a greater degree upon their own resources in extending accommodations while still affording an outlet for any undue accumulation of loans. Because of the exigencies of war financing, it has not been practicable for the Federal reserve banks up to this time to adopt this policy, and as a rule Federal reserve bank discount rates are lower than the rates charged by member banks. It is believed that conditions are gradually adjusting themselves so that Federal reserve bank rates may be maintained at a level slightly higher than the current rates not only without any disturbance to commerce and business but to their distinct benefit. In fact, this adjustment has already begun in some cities where members banks have reduced their rates on commercial paper.<sup>29</sup>

As this statement indicates, the System ignored charges that its actions were responsible for the behavior of the economy. The economic and social ramifications of its policies were acknowledged in private, but records of deliberations and policy actions were not available to the public. Reserve officials chose, therefore, to adopt a theoretical position which implied that the System had no influence on economic events. In addition, they cited the fact that the depression was world-wide in scope, the result of fundamental political and economic conditions which the System could not be expected to control. An angry delegation of the American Farm Bureau Federation appeared at the April, 1921 Conference of Governors, charging that they had "never been able to arrive at any person who wishes to shoulder

<sup>28</sup> *Minutes*, July 12, 1922 Meeting of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities (Federal Reserve Board, File no. 333.-a).

<sup>29</sup> *Agricultural Inquiry*, Hearings before Joint Commission of Agricultural Inquiry, 67th Cong., 1st Sess., Vol. 2, pp. 381-382.

the . . . responsibility for deflation." Governor Strong who, as noted before, was to endorse Dr. Miller's call for a liquidation of labor later that day and who adamantly opposed the rate reductions pushed through in April and May by Secretary Mellon, replied:

You inquire as to the man who gave this order for deflation. I know of no such order being given. It happens that during the year 1920 I was travelling. I had a year of leave. I reached Japan in the Spring of 1920 and found that this deflation order had been given there long before it was given here.<sup>30</sup>

Reserve officials also asserted that the System's influence on financial conditions was more limited in scope than its critics supposed. Noting that it had been constituted as a regional system for keeping the reserves of member banks rather than a central bank, they argued that "the volume of credit extended by the Federal Reserve System is under the exclusive control of the member banks in the System . . .".<sup>31</sup> The effect of its rate policies within the context of this naive and foolhardy, if not self-serving rationale was explained in a colloquy between Governor Harding and Congressman Ogden L. Mills of New York:

Rep. OGDEN L. MILLS (N.Y.): Now, Governor, I would like to ask you a question, and I know it is difficult to give an absolute answer to a general question of this kind; but, in your judgment, would not the drop in prices have taken place irrespective of the action of the Federal Reserve Board?

Governor HARDING: Unquestionably.

Rep. MILLS: Now, the only possible effect which the action of the Federal Reserve Board could have had in putting on the brakes was to protect the banks when the crash came, so that they could not have been caught?

Governor HARDING: That was it.

Rep. MILLS: And to assume that prices would be continued at their high level simply through the action of the Federal Reserve Board in maintaining the low discount rate is, from your standpoint, a fundamentally erroneous economic conception?

Governor HARDING: Yes, sir.<sup>32</sup>

The most elaborate and carefully reasoned exposition of the System's position is contained in Governor Strong's testimony before the Commission of Agricultural Inquiry in August, 1921. He argued that the System had merely acted as fiscal agent for the Treasury during the War, and that actual responsibility for policy had rested with the Secretary "under the limitations imposed upon him by the various acts of Congress authorizing him to borrow money and raise taxes." After the war, he explained, the System had proposed that rates be increased but the Treasury objected. The System could not act without Treasury approval because, again, it was "their agent and servant in these matters." Therefore, the inflationary policies of the post-war period were "matters that should be discussed by our principals." When the System finally did obtain the Treasury's approval to raise discount rates, it did so because the action was both "necessary and justified." "Without the adoption of that policy," Strong concluded, "this expansion which took place would have gone to unparalleled levels."

What happened next, in the first half of 1921, after "the period of the vertical fall in prices," was this:

<sup>30</sup> S.R., April, 1921 Conf., pp. 469, 492-496.

<sup>31</sup> *Ibid.*, pp. 8-25.

<sup>32</sup> *Agricultural Inquiry*, Vol. 2, p. 363.

... It then became necessary to encourage the banks to extend credit to those who needed it, in order to meet the difficulties of overburdened inventories, to which I referred, due to the backing up of goods, and in order to enable them to fulfill existing obligations and engagements that they had entered into, not only in connection with the greater volume of business in the expansion period, but in connection with the greater volume of business at a much higher level of prices. The strain upon credit then was the most difficult thing we had to meet, because then the question of goodness of credit for the first time entered into our problem.<sup>33</sup>

As this statement implies, the System was taking the position that there had been no restriction of real bills credit—credit to finance real or regular business activities—and thus no deflation. Governor Harding was more explicit in conversation with Senator Frank R. Gooding of Idaho during the October, 1921 Conference:

... Most of the trouble that occurred in 1919 was because the screws were not put on in time. A great deal of this inflation and consequent loss could have been prevented by earlier action. There were certain reasons why earlier action could not be taken, however. But the main trouble with this country right now results not from restriction of credit but from the too free granting of credit for a long time; and I think if you will take the trouble to analyze the situation, you will reach that conclusion. The banks were so loaded down with loans two or three years ago that they could not extend their regular business.

Senator GOODING: The deflation that has taken place has brought about that condition very largely ...

Governor HARDING: What is that?

Senator GOODING: Deflation has made it possible.

Governor HARDING: There has been no deflation.<sup>34</sup>

The topsy-turvy world described by Reserve officials was based on a specific set of definitions and theoretical assumptions. As noted earlier, "credit restraint" and "deflation" meant a reduction in the volume of member bank borrowing. It was thought that pushing the discount rate above bank rates and holding it there would accomplish this objective. Theoretically, this would have the effect of forcing the banks to liquidate loans before making new loans. While pressing the banks, however, it was necessary to provide an escape valve. As Governor Strong had advised, paraphrasing Walter Bagehot's so-called golden rule of central banking, the System must respond by lending freely at high rates.<sup>35</sup>

The System continued to adhere to this formula although it became increasingly apparent that it would not work. As noted above, member bank indebtedness had only decreased by \$400 million—from \$2.5 billion to \$2.1 billion—as of April 1, 1921. In the face of the lag in liquidation, Reserve officials thought they had no choice but to maintain discount rates at high levels. They agreed that the process could be hastened by abandoning Bagehot's classical admonition and curtailing accommodation, but recognized that this would be unacceptable. To press the banks further at that point would be to risk a money panic which would have certainly destroyed the System. The fact that they had failed to reduce the level of member bank indebtedness was turned to good account, however. Reserve officials cited these figures as evidence that they had not forced liquidations.<sup>36</sup>

<sup>33</sup> *Ibid.*, pp. 453–454, 501–503.

<sup>34</sup> *S.R.*, October, 1921 Conf., p. 398.

<sup>35</sup> *Ibid.*, p. 623. *S.R.*, April, 1921 Conf., p. 631. Chandler, *op. cit.*, pp. 173–174.

<sup>36</sup> *S.R.*, April, 1921 Conf., pp. 65, 107, 657, 660, 661, 813, 1063.

A description of the way in which liquidation had finally come about was provided by Governor Strong to the Joint Commission of Agricultural Inquiry:

... in this period, by gradual stages, with inventories being liquidated and debts being paid, gradually one after another of our member banks have paid off all that they owe us. They would in fact, pay off a 7 percent discount at the reserve bank, and especially those that were borrowing heavily, in preference to going into the market to make some other investment even at a more attractive return. This is partly due to the fact that banks do not like to owe large sums of money, and it is partly due to the fact that they have been educated in New York to the real purposes of the Federal reserve bank. I think that they understand it pretty well. And when a surplus reserve arises they know that we expect them to repay us and not employ the money in some attractive loan.

When, therefore, a member bank gets out of debt to the reserve bank and it has a surplus reserve balance, it has to seek employment for it, so it goes into the market to lend money, and if a number of them get out of debt at the reserve bank then we have a competition to lend money. They cannot get a 7 percent investment any more by paying us off. That is what introduced the new and cheaper credit into the market that reduced the interest level below the level of our discount rate.<sup>57</sup>

Although this analysis purported to explain how the penalty rate made it unprofitable for member banks to continue to expand their borrowings from the Federal Reserve System, it implied that actual reductions in borrowings were due to moral suasion, or, put bluntly, to the fact that the Reserve banks viewed discounting as a privilege not a right. The admission that banks would actually find it more profitable to use surplus funds in making new loans was fairly damaging to the assumption underlying the penalty rate theory, but went unnoticed. Also unnoticed was the fact that Governor Strong managed to avoid the principal issue raised by former Comptroller of the Currency John Skelton Williams, Secretary of Agriculture Henry C. Wallace and others; that the System should have relaxed its restrictive policy after the deflation began. As Lester V. Chandler comments, "one now wonders why the commission was so favorably impressed by Strong's arguments . . ." <sup>58</sup> The exchange between Governor Harding and Congressman Mills indicates, however, that many of the members of the commission thought the recession was an inevitable consequence of the inflationary policies of the Wilson administration. The argument that the System had succeeded in preventing a run on the banks during a crisis which it could not have prevented was as much a statement of the preconceptions of the commission as of the views of the System itself.

Meanwhile, the arguments of the System's critics were not without impact. As Secretary Wallace, Governor McKelvie of Nebraska and others pointed out, the System had ignored the fact that heavy gold inflows and the excess reserves they created actually justified a reduction in discount rates. Reserve officials continued to avoid any discussion of gold in public, but hastened to devise stratagems for segregating the gold reserve and masking its effect on reserve ratios. By the fall, however, the critics had a more damaging argument. As Governor McKelvie pointed out to the Board, local bankers had admitted to a conference of the governors of nine Mid-Western States that they

<sup>57</sup> Agricultural Inquiry, Vol. 2, pp. 506-507.

<sup>58</sup> S.R., April, 1921 Conf., pp. 5-8. S.R., October, 1921 Conf., pp. 579-581. Chandler, *op. cit.*, pp. 177, 181.

would have lowered rates much earlier had the discount rate been lowered.<sup>39</sup>

Somewhat alarmed, the Board conducted its own poll of member banks and sent a summary of the replies to the October, 1921 Conference of Reserve bank governors for discussion. It was clear to all that the argument for maintaining the discount rate as a penalty rate had been seriously weakened. One of the officers of the Boston Bank had already noted in April, 1921 that :

While it has generally been thought wise to keep the discount rate above the commercial rate, the continuation of high discount rates by Reserve banks after its necessity to control the volume of credit has passed, might logically be criticized as an endeavor to help the commercial bank in making more money.<sup>40</sup>

Most of the bankers polled by the Board—and the Federal Advisory Council as well—endorsed the classical view of the function of the discount rate, and urged that the high discount rates be maintained. Two bankers, identified only as being residents of New York and Milwaukee, had suggested that the rate be lowered during a period of recovery. The Milwaukee banker argued that the rate should be above the market “whenever the demand is excessive and when speculation or expansion is growing rapidly, but that it need not be above when loans are being paid off and liquidations are in process, as it is at the present time.” This statement was greeted by the governor of the Federal Reserve Bank of San Francisco with emphatic approval: “. . . that is the soundest (view) of any that has been enunciated.” But the governor of the Richmond Bank, reflecting the fears of the majority, argued that “when you put it lower, you lay the ground for expansion . . . That is exactly what the Federal Reserve System did, and it has gotten so far that it found difficulty against objections to raise its rates.”<sup>41</sup>

The assertion of such a view at that point—in October 1921—bears out Chandler’s observation that the “dominant guides to policy were financial rather than economic.” He notes that Reserve officials thought the System’s “dominant purpose should be to assure ‘sound’ financial conditions, which meant first of all maintaining gold payments and avoiding financial crises.” He concludes :

A central banker accepting this set of priorities naturally feared inflation more than deflation and insisted that on some occasions deflation was necessary for the attainment of primary financial objectives.<sup>42</sup>

Nevertheless, the experience of 1920–21 had made a profound impression on many Reserve officials. As the discussion of discount rates continued, Governor Morss of Boston interjected that he understood “that the Board favors the reduction of rates all around at the present time,” and Governor Strong added that he also had “heard that statement made.” The Board’s position, then, was clear. Asked for his opinion, Governor Strong argued against rate reductions. He agreed that the System should act to reduce market rates, but

<sup>39</sup> S.R., October, 1921 Conf., pp. 562–570.

<sup>40</sup> S.R., April, 1921 Conf., p. 552.

<sup>41</sup> S.R., October, 1921 Conf., pp. 614–620.

<sup>42</sup> Chandler, *op. cit.*, p. 183.

thought the market should be influenced downward by open market operations rather than rate reductions, because "you are not going to make money cheaper to the original borrower by reducing your discount rate." The governors of the Kansas City and Dallas Banks heartily agreed. Strong continued:

Whether there are means in Kansas City, for instance, of forcing rate reductions by commercial banks to their customers to such an extent that it will gradually extend over the district and effect a general lowering of interest rates, is a question I cannot pass upon. I know it is within our power in New York to influence lower levels of rates by the market operations of the bank, to some extent.<sup>43</sup>

As Governor Strong was to elaborate later, the discount rate could then be lowered, appearing to reflect rather than influence market conditions.

Whatever limitations Governor Harding had placed on the scope of Federal Reserve actions, Strong does not hesitate to suggest here that the System intervene in economic events or to note, in private, the effect of Federal Reserve policies on financial conditions. He was, however, unwilling to see the System subjected to the kind of pressure that would follow from an acknowledgement of the extent of its influence. Open market operations provided a means of control which could be exercised, as he subsequently put it, "without too great a red flag."<sup>44</sup> By minimizing the role of open market operations as a policy tool and perpetuating the idea that Reserve bank investments were primarily a means of covering expenses, it was possible to continue to maintain that the System's discount rates had no effect on the market and were, as Governor Harding had said, "merely an interpretation of . . . conditions."

The aura of subterfuge which characterizes Federal Reserve policy positions throughout this period was occasioned by the threat of some form of legislative action to make the System more responsive to economic conditions. Reacting defensively, the System had tended to minimize its powers, particularly those of the Board. Reserve officials were aware that their statements were somewhat lacking in candor. As Governor Norris of Philadelphia commented in April, 1921:

. . . we have anticipated for some time that the unpleasant consequences of a period of deflation would probably be blamed on the Federal Reserve System and particularly on the Federal Reserve Board, and with that thought in mind, we have perhaps spoken a little slightly at times of the power of the Board . . .<sup>45</sup>

Nevertheless, this position was adopted by Secretary of the Treasury Andrew Mellon in his first appearance before a Congressional committee, June 7, 1921, on behalf of the administration's amendment to the Farm Loan Act. Secretary Mellon's definition of the System's function was as follows:

The Federal Reserve System is merely the general banking organization of the country to function in industry generally, and the private banks, the private member banks, are the banks which do the business, which advance the money. It is not the Government's money; the Government merely has the fiscal organization for the deposit of the reserves of those banks.<sup>46</sup>

<sup>43</sup> *S.R.*, October, 1921 Conf., pp. 632-637.

<sup>44</sup> *S.R.*, November, 1925 Conf., pp. 208-209.

<sup>45</sup> *S.R.*, April, 1921 Conf., p. 30.

<sup>46</sup> *Amendment to Farm Loan Act*, Hearings before the House Committee on Banking and Currency on S. 1837, 67th Cong., 1st Sess., June 7, 1921, p. 9.

As this statement implies, there was an attempt to argue that the Federal Reserve System was not a central bank and that only a central bank could possess the powers ascribed to the System by its critics. It was convenient in evading criticism to suggest the diffusion of responsibility inherent in a regional system. There is, however, no indication in the record of deliberations within the System of any great respect for the principle of regionalism. In fact, there had been a consistent effort internally to centralize the System on both an administrative level and through operation of a System-wide open market account.

A majority of the proposals which resulted in greater centralization of the administration of the Federal Reserve banks through the Conference of Governors had been initiated by Benjamin Strong. Strong had solicited support for the Aldrich central bank plan and had opposed the Federal Reserve bill on the grounds that control of the System by political appointees rather than experienced bankers would be dangerous. Given the current tendency to minimize the Board's powers for reasons of expediency, Strong took the opportunity to press for an actual curtailment of its powers. During the April, 1921 Conference, he argued that the Reserve banks should have the dominant voice in determining policy because, while they "may differ as to rate policies . . . in the long run (they) are in a better position to escape the most dangerous kind of pressure, not the pressure of member banks, but the pressure right up here in the Capitol." He argued further that:

. . . What this System requires is protection against misled public opinion, which will be reflected in Congress, in some foolish act by Congress, and I must say in all frankness that I believe the Federal Reserve Board is very vulnerable, if it exercises that control; much more so than are these twelve reserve banks undoubtedly. If the Federal Reserve Board is in a position to say in response to these demands. "We do not control these reserves, we have not got the power to shovel a hundred or two hundred or give hundred millions of gold into the reserve of the Reserve banks, the question is answered at once, and my experience, through every administration that I have been through, indicates that there is always going to be pressure applied to the Federal Reserve Board."<sup>47</sup>

By October, the kind of pressure Strong described had increased the number of his allies. Even the governors of Reserve banks in Southern districts, who had consistently been more responsive to the needs of farmers and more tolerant of their efforts to put pressure on the System, were echoing Strong's position:

Governor WELLBORN (Atlanta). . . You do not see a lot of Congressmen coming . . . here from our district or your district.

Governor SEAY (Richmond). They go to the Board . . .

Governor WELLBORN. They abuse the Federal Reserve Board, but not the banks.

Governor SEAY. No, because they cannot make out a case against the bank.<sup>48</sup>

The generally negative reaction of System officials to the pressure for easier credit had the effect of increasing efforts to change the structure of the System. In March, 1922, hearings were held on a proposed amendment to the Federal Reserve Act which, when enacted, added an eighth member to the Board as a representative of agricultural interests. The Federal Advisory Council had petitioned President Harding to oppose the legislation on the grounds that the com-

<sup>47</sup> S.R., 2nd Conf. (1915), pp. 457-463. S.R., April, 1921 Conf., pp. 1094-1096, 1101-1103.

<sup>48</sup> S.R., October, 1921 Conf., p. 469.

position of the Board should reflect "an entirely judicial point of view, uninfluenced by the wishes of parties or classes." Governor Strong had suggested as early as 1915 that the functions of the Board be limited to those of a "judicial body", but the Board, led by Governor Harding, had emphatically overruled Strong at that time and had retaliated by curtailing the powers of the Governors Conference. At this point, however, it was willing to accept this definition of its function. Secretary Mellon appeared as a witness against the amendment and told the House Banking and Currency Committee that:

The Federal Reserve Board does not pass upon paper from agricultural regions and has no latitude as to what may be discounted . . . The board is just a regulative board, and it is the individual Federal Reserve banks which exercise discretion as to the extent of accommodation to the member banks.<sup>49</sup>

One of the Democratic members of the Committee, Eugene Black of Texas, questioned this interpretation of the law:

As I understand it, the Federal reserve banks are under the control of boards of directors, but the policies of the banks, within the limits of the law, are determined largely by the Federal Reserve Board.

In reply, Secretary Mellon rephrased the law as follows:

The Federal Reserve Board has general supervision of the Federal reserve banks and has authority to correct anything which it believes to be unsound in policy.<sup>50</sup>

This statement is significant in view of Secretary Mellon's efforts during March and April, 1922 to repress the open market authority of the Federal Reserve banks. The extent to which the Reserve bank purchases of Government bonds had influenced rates downward in this period was not generally known. However, Secretary Mellon's negation of the Board's powers was challenged by another member of the administration. Testifying in favor of the amendment, the Secretary of Agriculture, Henry C. Wallace—father of a subsequent Secretary of the Department and Vice President—told the Committee:

I have not thought of the Federal Reserve Board as a purely administrative body, but rather as an institution which determines the general financial and credit policies of the country, and from that standpoint, I am not able to agree with the suggestion that a larger membership would be inadvisable. On the contrary, it seems to me that the membership of a board, which in time, if not now, will, through the exercise of its administration of the great credit machinery of the country, have a very direct influence upon prices and upon business in general should be a cross section of our industrial life, including agriculture—I am not using the words "industrial life" in a restrictive sense. Such a board might well represent a cross section of the entire business life of the nation . . .

The board should be made up of men who have a keen understanding and full appreciation of the effect of every policy of this board on agriculture, industry, commerce, labor, and other large interests, because the administration of this credit machinery can make or break labor as well as agriculture.

Pursuing the implication of the Secretary's statement, Congressman Brand of Georgia asked:

Do I understand you to say, then, that the Federal Reserve Board can adopt such policies as would have the effect of increasing or decreasing the price of agricultural products?

<sup>49</sup> *Amendments to Federal Reserve Act, Hearings before the House Committee on Banking and Currency on S. 2263, 67th Cong., 2nd Sess., March 15-16, 1922, pp. 6, 17-21. S.R., 2nd Conf. (1915), p. 458. Summary, 5th Conf. (1915), p. 9. S.R., January, 1916 Conf., pp. 2-10.*

<sup>50</sup> *Amendment to Federal Reserve Act, p. 9.*

Secretary Wallace replied: "Why, certainly, it can."<sup>51</sup>

Following Secretary Wallace and testifying against the amendment, Governor Harding restated the argument on the limitations of a regional system which the Board had used in its 1921 *Annual Report*:

The (Reserve) banks are localized. Each Federal reserve bank is an independent entity, as you will see if you will read section 4 of the Federal Reserve Act, which describes the powers of the Federal reserve banks. The duties of the Federal Reserve Board, as pointed out by the Secretary of the Treasury, are largely supervisory and, in a general way, administrative. But the powers of the Federal Reserve Board have been grossly exaggerated. I do not think the Secretary of Agriculture has a correct conception of the functions of the Federal Reserve Board, with all due respect to him.

The board cannot exercise, under the law, any such influence on prices as he seems to think it can.<sup>52</sup>

This statement by Governor Harding was, of course, consciously deceptive. All rate changes throughout 1921 had been initiated by the Board—those in May which had been actively opposed by Governor Strong as well as the more dramatic reductions at the end of the year.<sup>53</sup> However, it is one of the ironies of Federal Reserve history that the System was already moving irrevocably in the direction of centralization through open market operations in Government securities, and that, because of these operations, the influence of the larger Reserve banks—especially the New York bank—was enhanced while that of the Board diminished. It is possible to argue that the ineffectual posture the Board chose to adopt contributed to the decline in its influence. While the testimony of Governor Harding and Secretary Mellon is less than a candid appraisal of the current powers and influence of the Board, in retrospect it resembles a classic case of the self-fulfilling prophesy. By the end of the decade, its function was almost as limited as the System had judged it expedient to proclaim in the aftermath of the 1920-21 depression.

#### 4. Reserve ratios, gold and foreign exchange

While the majority of Americans coped with the effects of a serious economic recession during the Spring of 1921, Federal Reserve officials

<sup>51</sup> *Ibid.*, pp. 23, 25.

For a discussion among Reserve officials of the System's influence on prices, see chapter V, part V, and appendix A.

<sup>52</sup> *Ibid.*, p. 27.

The 1921 Annual Report had stated:

"Attention should be called, first of all, to the fact that the Federal Reserve Act did not establish a central bank. On the contrary, it adopted the regional principle and authorized the establishment of not more than 12 banks, to be located in various sections of the country. Each of these banks is practically independent of the others in operation as well as in local policies. From a legal standpoint, these banks are private corporations organized under a special Act of Congress, namely, the Federal Reserve Act. Their stockholders are their member banks, each of which is required to subscribe to the capital stock of the Federal Reserve Bank an amount equal to 6 percent of its own capital and surplus, one-half of which amount is required to be paid in" (*Annual Report of the Federal Reserve Board*, 1921, pp. 90-91).

It should be noted that, unlike the Joint Commission of Agricultural Inquiry, the House Committee was not persuaded by the System's argument and that the amendment to add a representative of agriculture to the Federal Reserve Board was enacted. The views of the Committee on the powers of the Board were reflected in the following discussion between Governor Harding and two Republican Members:

Mr. KING (Illinois). I am not saying it is unfair, but I am getting at whether your rulings really affect the prices of commodities.

Governor HARDING. I do not think they do.

Mr. KING. I have always thought so.

Chairman McFADDEN (Pennsylvania). Your rulings are always interpretations of the law?

Governor HARDING. They are always interpretations of the law, and conservative interpretations rather than the reverse. (*Amendment to Federal Reserve Act*, p. 32).

<sup>53</sup> S.R., April, 1921 Conf., pp. 674-679, S.R., October, 1921 Conf., pp. 632-637. Chandler, *op. cit.*, p. 174.

worried about the possibility of a run-away inflation. Gold had flowed out of the country in 1920 after the suspension of war-time controls prohibiting its exportation. However, it had suddenly begun to flow back in unprecedented amounts in response to the decreases in prices in the United States—especially agricultural prices—and to the fact that U.S. interest rates had increased sharply after November, 1920, and failed to decrease even though prices of goods continued their sharp downward descent begun in May. Reserve officials ignored the relationship between these inflows and high interest rate levels, concentrating instead on various methods of hiding the increase in reserves in order to avoid rate reductions. Dr. Miller stated the problem during the April 1921 Conference:

. . . if our reserve ratio is not a better indicator of domestic credit conditions than it is at the present time, it is a very faulty indicator . . .

Either the Federal Reserve System has to discard for itself the reserve ratio as a matter of no particular consequence in determining its discount and credit policy, or it has got to face the extremely difficult and I think impossible task of maintaining high rates with a rising reserve ratio.<sup>54</sup>

As Dr. Miller implied, there was already pressure on the System to lower rates in view of the rising reserve ratios. Secretary Wallace had made such a proposal in a recent editorial in *The Farmer* and similar suggestions had originated elsewhere. Governor Strong was aware of the pressure but thought he had a different solution. Commenting on Dr. Miller's observation, he said:

The pressure in New York comes from the class of people who have practically no political influence, and we are not afraid of them—the stock exchange fellows. We have got them tamed. It is these farmers that I am afraid of, and we will buy paper from the other Reserve Banks just as fast as they get it, to keep our reserve down. I am not afraid of that.<sup>55</sup>

But as Dr. Miller noted, this would solve nothing. If New York kept its reserve down in this way, somebody else's reserve would be up. He suggested instead a change in bookkeeping arrangements. Rather than list a combined reserve, the System could segregate reserves, put the gold into the note reserve and educate the public to look at bank reserves "as an indicator of the credit situation." The Governor of the San Francisco Bank objected that it would be almost impossible to get the public "to look at anything except the high reserves, wherever it appears." Governor Strong offered still another solution. Put the gold "in cold storage"—that is, "earmark" it and:

. . . leave the gold abroad where it would not count in our reserve calculations, but where our payment for the gold would actually increase the amount of our credits, supported by reserves that we do count in our reserve calculation. The effect of that would be actually to contract our reserves every time we get an addition to our gold. Of course, the justification for such a policy would be that it would be contemplated that the gold is later to be returned to Europe, when exchange conditions make it possible, and the gold will be there handy for return, and we will save the risk and expense of shipping it twice across the ocean.<sup>56</sup>

Strong's suggestion was put into effect temporarily but a third solution was suggested by the new Treasury officials in October. As explained to the Conference by Governor Strong, it entailed:

<sup>54</sup> *S.R.*, April, 1921 Conf., pp. 1089-1090.

<sup>55</sup> *Ibid.*, pp. 5-8, 562-581, 1090.

<sup>56</sup> *Ibid.*, pp. 904-905, 1091-1093.

. . . putting gold certificates into circulation for the definite purpose of reducing the reserve percentages of the Reserve Banks and thereby indirectly relieving the pressure for lower discount rates, or, if you please, soft money, as distinguished from a proper discount policy and hard money.

As implied, Strong considered this proposal inherently inflationary and there is no doubt but that the Treasury program, when put into effect at the end of 1921, did serve as an inadvertent aid to recovery. Even so, it was criticized by Governors Calkins and Strong as partaking of "subterfuge" and leaving the System open to hostile criticism. Under Secretary of the Treasury Gilbert replied that the System was under attack already and rightly so, because "the Federal Reserve Banks have been in the attitude of hoarding the gold, and they still are."

The hoarding psychology was, however, hard to defeat. During the October 1921 Conference, when the question of paying out the gold was brought up, Governor Seay of Richmond argued that:

. . . the gold is where it ought to be. It took a great deal of trouble to put it into the Federal Reserve Bank, and if we could get all of the gold in the country into the Federal Reserve Bank it would be a good thing, I think.

And Governor Miller of Kansas City concurred:

I am opposed to paying out gold. I think we have accumulated it at great expense and I think it would be a step backward to pay it out now.<sup>57</sup>

It is perhaps inevitable that any central banking system would be distracted by the discovery that it is suddenly and for the first time the repository of a majority of the world's gold supply. Nevertheless, such a situation is one which required serious consideration and, between the April and October, 1921 Conferences, Governor Strong had given it some thought. As his earlier proposal indicates, he was concerned as much with the international implications of the gold inflows as with domestic considerations. During the October, 1921 Conference, he proposed an increased volume of open market purchases to bring rates down rather than a reduction in the discount rate. The argument for this proposal was as follows:

. . . we cannot afford in this country to impound all the monetary gold in the world and lock it up and not permit the world to do banking here and borrow money here. In other words, we are shutting down on the world's recovery and closing our markets, if we require gold payments for everything, and then don't use some of that gold as the basis of some extension of credit, and we feel in New York that the general recovery of trade around the world is going to be brought about by our making New York a good market in which the world can borrow money, and that applies to the whole country, but New York is where they first come.<sup>58</sup>

Strong also believed that lowering rates through open market purchases by the Reserve banks would be the better way to aid domestic recovery, but showed none of the deep concern for domestic conditions that he was to manifest following the recession of 1924. Chandler suggests that Strong simply had not, at this point, outgrown his pre-war concepts of central banking, and while this is evidently true, it is also true that he was deeply absorbed in the first of the international ventures which were to play a significant role in his subsequent career.<sup>59</sup>

<sup>57</sup> S. R., October, 1921 Conf., pp. 90-91, 95-96, 99, 374-377.

<sup>58</sup> *Ibid.*, pp. 635-636.

<sup>59</sup> *Ibid.*, p. 637. Chandler, *op. cit.*, p. 181.

During the October 1921 Conference, Strong asked the governors to join, as a System, in a proposal he had initiated to stabilize exchange rates. It would mean, he explained, entering into an agreement with foreign central banks to set up a pool to operate an exchange account. Introducing the proposal, Strong commented :

. . . my belief [is] that whether we want to or not we are going to have to take some part in this situation abroad. We probably won't do it politically, but we have got to do it financially and economically.

The governors were wholeheartedly in favor of the concept. In view of the fate of President Wilson's proposals, it is interesting that this group should endorse such a view as was expressed in the following statement by Governor Norris of Philadelphia :

I am bound to say that I think the three great opportunities that we have had to accomplish the stabilization of foreign exchange were, first, to go into the League of Nations; second, to make a readjustment of our tariff with a view to opening our doors to export as far as it could be done with the least disturbance to our industries rather than put up barriers. Neither of those things has been done or will be done, and the third was to empower the Secretary of the Treasury to deal in an intelligent way with the refunding of foreign obligations . . . [and] the limitations that have been written into the bill will make it impossible for him to do anything of any real use . . . But because we have lost those three, it does not follow, of course, that we ought to throw aside and discard all others . . . [and] it seems to me that the proposition you have suggested is one that undoubtedly has merit and may reasonably be expected to accomplish some results.

Governor McDougal of Chicago assured Strong that if the plan "can be worked out on a safe and workable basis, that the entire System will be sympathetic." It was therefore agreed that Governor Strong should proceed with his negotiations with foreign central banks. While the foreign central banks involved were, as Governor Strong noted, "themselves controlled by acts of their own legislatures," a fact which might impede the arrangements, the certainty of a Congressional veto of Federal Reserve participation could be avoided. He suggested that the System participate in the pool through the current account which the law authorized the Federal Reserve banks to maintain at foreign banks appointed as their agents or correspondents, settling with gold shipments as necessary.<sup>60</sup>

This proposal was a significant first step by American authorities in the direction of full participation in international financial arrangements. It need only be noted here that the *modus operandi* of this first operation served as a model for Strong's subsequent actions. He not only avoided seeking Congressional approval for foreign operations, but, finding a direct relationship with the Treasury more congenial, avoided consulting the Federal Reserve Board as well. Given the quasi-governmental status of the New York Reserve Bank and the backing of sympathetic Treasury officials, Strong was able to transform the Federal Reserve Bank of New York into a central bank dealing with international finances as effectively as its European counterparts.

<sup>60</sup> S.R., October, 1921 Conf., pp. 721-741.

## CHAPTER V

### THE EVOLUTION OF THE OPEN MARKET COMMITTEE

#### 1. *Centralization of open market operations in bankers' acceptances: 1919-20*

While the Federal Reserve banks, through the Conference of Governors, had developed a sophisticated mechanism for centralizing open market operations before the United States entered World War I, the market itself was largely undeveloped. It consisted of a limited amount of bankers' acceptances, municipal warrants and the \$1 billion of 2 percent bonds securing the national bank circulation. The Liberty Loan issues created within a two year period a class of securities in the amount of \$25 billion which were a ready-made marketable instrument, but the Reserve banks chose to ignore this development and to remain inactive in the market during the war. One reason for this inactivity was that earnings from discount operations were more than sufficient to cover expenses. More fundamental however is that under the prevailing "real bills" conception of economic processes Reserve bank purchases of Government securities were believed to supply funds for speculation and to fuel inflation, whereas discounting and purchasing bills of exchange arising out of commercial transactions (bankers' bills or acceptances) were viewed as supplying funds for productive purposes.

The new open market policy devised during the March 1919 Conference continued to reflect the "real bills" doctrine. For the first time it was proposed that open market operations be used as a tool of policy independent of the question of Federal Reserve bank earnings. This proposal was contained in a set of guidelines offered by the Federal Reserve Bank of New York which recommended that transactions in bankers' acceptances of all Reserve banks be coordinated as a means of developing the market for these bills. The focus on bankers' acceptances reflected the requirements of "real bills" that commercial paper serve as the primary basis for the extension of Federal Reserve credit.

In line with this requirement, it was suggested that the Reserve banks act primarily as agents for their member banks, encouraging investments in bankers' acceptances and purchasing, holding and collecting bills for their accounts. The purchases of the Reserve banks for their own accounts were to reflect their role in supporting the market for bankers' bills. It was recommended that they sell bills only to other Reserve banks. Sales in the open market were, as Mr. Kenzel, the manager of the New York Bank's open market account, explained:

... a function of dealers in discount, and I do not think it is the proper function of banks to distribute bills. That is a specialized business and belongs to the dealers in the market and (sic) who should be recognized in it, and the Federal Reserve Banks should not be competitors of theirs. They may, however, I think, very properly be buyers in the market for member banks.<sup>1</sup>

<sup>1</sup> *Stenographic Record*, March, 1919 Conference, p. 329. The emphasis was on seeing to it that "those bills stay sold, that they do not come back into the market" (*S.E.*

Concern for dealers was also reflected in Governor Strong's proposal for repurchase agreements as a means of insuring them "a sufficient supply of credit with which to carry (bills), without penalty of a high rate, until they are able to market them."<sup>2</sup>

The last but not least important of the New York Bank's proposals emphasized the need for consultation among the Reserve banks regarding the volume of transactions and prevailing rates in a given district when a Reserve bank was buying bankers' bills outside its own district. The Federal Reserve Board also wished to be consulted. The extent of its supervisory powers over open market operations was not clear. However, it had inserted into the guidelines at the conference a requirement that all sales of bills by one Federal Reserve bank to another "promptly be reported to the Federal Reserve Board." Arguing by analogy, it noted the similarity between the extra-legal arrangements for allotment of System investments and the legal provisions under which the Board could compel one Reserve bank to rediscount the paper of another. The Board pointed out that these actions had the same effect on reserve ratios and that, therefore, it had a vital interest in any arrangement for shifting investments among the Reserve banks, since such an arrangement could serve as an alternative to rediscounting.<sup>3</sup>

The Board's position in effect sanctioned New York's proposal that there be some means of coordinating information on open market transactions. The method adopted by the conference at the further suggestion of the New York Bank was "that where one Federal Reserve bank takes its bills in another Federal reserve district, it should be through the bank of that district."<sup>4</sup> Since New York was the primary market, the potential effect of this plan was to return to the New York Bank the position of control over the open market transactions of the Reserve banks which it had held in the pre-war period. The arrangement was not discussed in this context during the March, 1919 Conference, nor was there any allusion to the pre-war arrangement which it resembled. However, the officers of the New York Bank raised the issue of the pre-war system of distributing investments during the April, 1920 Conference, and made an overt proposal for centralizing open market transactions through that Bank. Speaking for New York during Benjamin Strong's absence, Vice-Governor J. H. Case said:

. . . you all know when the Federal Reserve System was established, all of the banks did participate in our purchases . . . Now, we think that (once again) those purchases should be for the account of all the Federal Reserve Banks . . .<sup>5</sup>

Case noted that, while the banks had participated before, they "dropped out" in the "stormy weather during the war period," leaving the New York Bank "holding the bag" with a portfolio of \$300,000,000 in bankers' acceptances. Currently only three banks—San Francisco, Chicago and Cleveland—were participating in the arrangement.

April, 1920 Conf., p. 406). A year later, the New York Bank reported that over a hundred member banks had subscribed to its service "in the matter of purchase of bills for their account and the holding of them and collection of them for their account" (*Ibid.*, p. 405).

<sup>2</sup> *S.R.*, March, 1919 Conf., pp. 356-357.

<sup>3</sup> *Ibid.*, pp. 329-330, 358.

<sup>4</sup> *Ibid.*, p. 359.

<sup>5</sup> *S.R.*, April, 1920 Conf., p. 439.

... and we feel that this principle is correct, and I think it is, that we are the financial center, and these bills flow in there, and at a time when they could not be absorbed by member banks, and were not absorbed, we stood in the breach and were a place of last resort.<sup>6</sup>

Several of the Reserve Bank governors explained that they had ceased to participate in New York's purchases because their reserves were low and they would have had to rediscount with another Reserve bank. It was noted that the New York Bank's reserves had fallen below the required ratio during the latter part of 1919, precipitating "headlines . . . stating that they were below their legal limit" in "every financial paper in this country." However, New York used this as an arguing point in its campaign for distributing investments.<sup>7</sup> The argument was made by the governor of the San Francisco Bank, J. U. Calkins:

... the Federal Reserve Bank of New York, being in the financial center in order to support the situation, may be overloaded, while the rest of us have no load to carry . . . the (reserve) position of the twelve Federal Reserve Banks cannot be comparable unless the purchases in the open market are distributed proportionally among them.

Governor Fancher of the Cleveland Bank also endorsed New York's argument:

... Bills go to New York; that is where they all center, that is the market and I think that there is an obligation upon us that we should carry in our portfolio an amount of bills equal at least to the amount of bills made in our district.

... simply because one of the banks or two or three of the banks may be low on their reserves . . . the load should not be dumped upon New York. They might be low in their reserves at the same time, but they are in a position where they cannot avoid it. Those bills have got to find a market.<sup>8</sup>

But there was a more fundamental reason for the opposition to control of System open market transactions by the New York Bank. New York's plan for developing the market for bankers' acceptances included maintaining relatively low buying rates for bankers' bills.<sup>9</sup> After the discount rate increases in November, 1919 the Treasury had to make substantial purchases to stabilize the Government bond market. Under Secretary of the Treasury Leffingwell complained that, because of Strong's low buying rates, the market for bankers' acceptances had not been affected by the discount rate increases, and told the Board that:

<sup>6</sup> *Ibid.*, pp. 439-440.

<sup>7</sup> *Ibid.*, pp. 439-442, 446-447. S.R., November, 1919 Conf., p. 266.

<sup>8</sup> S.R., April, 1920 Conf., pp. 440-443.

A subsequent statement by Governor Calkins in support of the New York Bank gives a more elaborate exegesis of the current rationale for distributing its investments: ". . . As I understand it, the system has set up what is known as a pipe line, and the purpose of that system of pipe lines is to establish a level in all the twelve Federal Reserve banks, in other words, to operate the banks as one system and the failure on the part of the twelve banks to carry their part, each one, of the bankers' acceptance load, is going to put the pipe line out of commission so that it will not operate. . . . Now if it is desirable that the reserve of the Federal Reserve Bank of New York should sink below that of the Bank of San Francisco, then of course we should stop participation and the Board would call upon us to rediscount with the Federal Reserve Bank of New York. We are trying to make the pipe line work, and the question is whether it is desirable to have a very wide difference in the reserve positions of the twelve banks or whether it is desirable to have a fairly level position of the twelve banks. That is the principle involved. If it is desirable to have the level in one district widely different from the levels in all the other eleven districts, why certainly we could not make any such agreement. I believe the Federal Reserve Board is more or less committed to the view that it should be kept up. There are difficulties, to be sure, in the matter of adjusting the basis, because of the fact that in some of the districts there is something approaching an open market, some of the districts besides New York, but that is a matter of easy adjustment." (*Ibid.*, pp. 454-455, emphasis supplied).

<sup>9</sup> S.R., March, 1919 Conf., p. 356.

If Governor Strong would apply to the bill market the same doctrine that he seeks to impose upon the Treasury, the situation would be well met.<sup>10</sup>

The low buying rate for bankers' bills was also opposed by Charles A. Morss, governor of the Boston Bank. He objected to New York's argument that the need for earnings had provided the rationale for distribution of its purchases in the pre-war period, having thought then, as currently, that the primary objective was to protect the New York Bank in terms of rates. Kenzel agreed that, "It was a question, then, Governor, of stabilization of rates, to prevent them getting too low," and Governor Calkins added that it "was for the benefit of all the banks."<sup>11</sup> Those who favored an active open market policy spoke up:

Governor CALKINS. What would the situation be if New York did not buy acceptances that were offered in the market?

The CHAIRMAN (Governor McDougal of Chicago). There would not be any market.

Mr. KENZEL (New York). I will tell you what I think would happen, and that is that a great amount of financing which is now being done in the form of acceptances would continue to revert to financing under promissory notes, those notes would clog up in other districts, and the other districts would be re-discounting promissory notes instead of bankers' bills.

Governor CALKINS. That means, in its last analysis, that the Federal Reserve Bank of New York, by buying acceptances in New York in the open market, is carrying a part of the load of each of the other eleven banks?

Mr. KENZEL. That is it precisely.<sup>12</sup>

But Governor Morss was not convinced. He refused to participate in an arrangement which authorized the New York Bank to conduct and control open market operations for the System as a whole. He felt that the Boston Bank had a right to independence of action and judgment, and that it had a responsibility to its own regional market:

Governor MORSS. . . . I should not think of participating in bills bought by the New York bank. We have an open market of our own, and we take care of that market as best we can . . . I cannot see how we could agree to take any amount or certain proportion of any amount of bills bought by the New York bank and pretend to take care of our own market at all.

Furthermore, we do not always agree with the rate at which New York buys the bills. . . . That, of course, is simply a matter of judgment, but I cannot see any reason why the Boston Federal Reserve Bank should be allotted a proportion of purchases by New York if it does not agree with their judgment.

Mr. KENZEL. It should not.

Governor MORSS. That is what we would do if we should agree to take a certain proportion.

Mr. KENZEL. You should not do so. I feel this way, if we take the larger view of it, of the necessity for stabilizing the open market as an obligation to the system, a way should be worked out whereby all the Reserve Banks would be consulted and would formulate policies and so forth. I do not wish to assume the responsibility, acting for the Reserve Bank of New York, of dictating policies for the system.

This last statement was subsequently transformed into the following motion adopted by the Conference, to the effect that:

" . . . it is the sense of this meeting that stabilization of the open bill market is incumbent upon the system as a whole and that a committee be appointed by the chairman to develop an equitable basis for making such support effective."<sup>13</sup>

<sup>10</sup> Board meeting, November 26, 1919 (*Board Records*, discount rate files, 1919).

<sup>11</sup> S.R., April, 1920 Conf., pp. 446-447. Governor Morss replied that, while "I do not want to be disagreeable about it . . . , I really think New York makes rather too much of that argument." (*Ibid.*, p. 447).

<sup>12</sup> *Ibid.*, pp. 447-449.

<sup>13</sup> *Ibid.*, pp. 451-453, 455.

The committee appointed to resolve the problems of open market policy was composed of Governors Morss and Fancher and Mr. Kenzel, representing the Boston, Cleveland and New York Banks respectively. Like its composition, its recommendations indicated an attempt to accommodate different points of view. Its first recommendation—that there be an emphasis on developing local markets in each Federal Reserve district—was proposed by Governor Morss. New York's emphasis on centralization as a means of developing the market for bankers' bills was reflected in a recommendation that the Reserve banks buy bills without regard to the amount created in their own districts and that the Reserve banks stand behind bankers' acceptances "unreservedly."<sup>14</sup>

The position of the New York Bank was also apparent in a notation in the committee report to the October 1920 Conference of a gross inequity in the distribution of bills, 90 percent of the total being held by only five Reserve banks. But New York's proposal that a plan be adopted whereby each Reserve bank would agree to take its portion of bills bought by other Reserve banks "under any and all circumstances" was vetoed by Governor Morss. He argued that a plan of allotment would necessarily interfere with the development of local markets.

The committee had recommended that it be replaced by a standing committee empowered to suggest buying rates for open market purchases of bankers' bills. This, it was implied, would curb New York's control over the pricing of System transactions. Governor Morss had objected to the fact that the New York Bank habitually offered lower rates for bills than were offered by the other Reserve banks, and that this had the effect of drawing all bills to the New York market and creating a false rationale for distribution of the Bank's portfolio. Governor McDougal had complained that the low rates offered by New York made it practically impossible to move bankers' acceptances on the open market and argued that, if the rate were right, the System would not need to take up so many bills.<sup>15</sup>

Meanwhile, another major disagreement had arisen between the New York and Chicago banks over New York's policy of discouraging the sale of acceptances by the Reserve banks. Shortly before the October 1920 Conference, the Chicago Bank had wired New York instructions to sell \$25 million of indorsed bills for its account. It did so on the grounds that it needed the funds to meet the rising demand for rediscounts from its member banks and that, there being a shortage of prime bills, sales would not disturb the market. The New York Bank wired back that Chicago was within its rights but that sales of indorsed bills were contrary to the statement of policy approved earlier by the Governors Conference to the effect that:

Federal Reserve Banks, like all central banks, being the places of ultimate rediscount, should not be traders and that paper which has been taken out of the market by Federal Reserve Banks through purchase should not again be found in the market.

The Chicago Bank had replied that "if we continued to participate in the purchase of New York bills, it would be with the understanding

<sup>14</sup> *S.R.*, October, 1920 Conf., pp. 31-39.

<sup>15</sup> *Ibid.*, pp. 33-39, 54-55.

that there are no restrictions, implied or otherwise, which would deny us the privilege of freedom of action in connection with the bills purchased." Presenting the case for the Chicago Bank to the October 1920 Conference, Governor McDougal launched a general attack on the policy of discouraging sales of acceptances. He argued that such a policy destroyed the value of bills as a "quick asset" and took exception to New York's position that sales of indorsed bills would mean they would be "hawked around, to the embarrassment, if not the detriment of the indorser," because:

We understand it has been the practice of the Federal Reserve Bank of New York, when buying bills from dealers, to require them to obtain a bank indorsement, and that the banks are paid a commission by the dealers for their indorsement. This might account for the objections of New York banks to having bills bearing their indorsement sold in the open market, as they are probably liable for a large amount of bills which they have never owned, but which have been indorsed merely as an accommodation to dealers.<sup>16</sup>

In reply, Governor Case argued that, due to continuing weaknesses in the market, the procedures adopted at the March 1919 Conference were still valid. It was necessary to restrict sales of bills by the Reserve banks because:

In a market so delicately adjusted . . . it will readily be seen that the offering of a round block of bills by a Federal Reserve Bank would seriously affect the market rates, based on supply and demand, irrespective of the entire probability that the fact of the offering would be interpreted as a contemplated increase in buying rates by the Federal Reserve Bank offering the paper.

Governor Case concluded that, therefore:

If a central bank becomes a trader in a discount market, the weight of its operations would tend to make it the market and not the stabilizer and controller of the market, which would be a misconception of the function of a central bank as judged by the historical standards and experience.

But, the New York Bank had already conceded that Chicago had the right to sell the bills in its possession regardless of the policy recommendation. Governor McDougal concluded the discussion with the comment that "the Chicago Bank does not feel that the recommendation contained in this report of Mr. Kenzel is binding upon the Chicago Bank, and in view of the fact that the New York Bank has told us it really is not binding, we are of course satisfied."<sup>17</sup>

Again, however, there was an effort to resolve differences. A standing committee was appointed composed of the same three members who had formed the initial committee. Empowered to suggest rates, it could, Governor Calkins argued, rectify "the objectionable practices in New York, if there are any, and if they do that they remove all arguments that have been made against this pro rata distribution."<sup>18</sup> Nevertheless, as the narrative of these discussions indicates, there was a natural tendency within a system of 12 Reserve banks to retain the regionalist cast intended for the System. New York's efforts to dominate the System were met with hostility and its attempts to centralize open market operations were consistently thwarted by other Reserve banks seeking to maintain functional independence.

<sup>16</sup> *Ibid.*, pp. 39-46.

<sup>17</sup> *Ibid.*, pp. 106-111.

<sup>18</sup> *Ibid.*, pp. 47, 111-114.

The refusal of the majority of the banks to endorse an allotment system during this period undoubtedly curtailed the amount of investments purchased. In retrospect, the reluctance of the governors to participate in New York's purchases in 1920 in view of their low reserves and, more fundamentally, because of their opposition to the low buying rates set by New York was at least as reasonable a response to overall economic conditions as was the policy of the New York Bank. Given the attempt to contain the expansion of bank credit, by raising discount rates beginning in November, 1919, New York's open market policies of low buying rates and prohibition against sales indicates that it did not fully understand the effects of these policies on the money market.

This lack of congruity between the discount rate and open market policies of the New York Bank indicates that the "real bills" doctrine continued to be the conceptual framework for policy. An increase in the quantity of commercial paper was not seen as inflationary because it was thought to represent the needs of trade. It was anticipated that such paper would be liquidated automatically when goods were sold because it expanded and contracted in response to seasonal factors without creating permanent additions to bank reserves. On the other hand, an increase in the amount of Government securities held by the banking system was the gauge for inflation. Government securities were not directly tied to loans for productive purposes and were viewed as the instrument through which the banks supplied funds for speculation. Therefore, it was thought that the low buying rates and enlarged purchases of acceptances would insure a sufficient volume of credit for productive purposes despite the increases in discount rates, while the higher rate for loans to member banks against Government securities and restrictions on investments in Government securities by the Reserve banks would tend to discourage the extension of bank credit for non-productive purposes.

The idea that a given market instrument would reflect a specific allocation of credit was discarded by Governor Strong after 1921, but revived by Roy Young as governor of the Federal Reserve Board in 1928. Also revived in that period—by George Harrison, Strong's successor at the New York Bank—was Strong's policy of making substantial purchases of acceptances as a margin of protection against a financial panic when discount rates were raised to levels which would force liquidations.

## *2. The 1921 open market operations of the New York bank*

After October 1920, the System's interest in open market operations waned. The report of the standing committee to the April, 1921 Conference was passed over in view of more pressing concerns, but the committee continued to function. In its report, it defined its function as follows: to study the market and suggest rates which would conform to market conditions; to develop uniform practices and conditions in the market; and to work toward broadening and developing the market for bankers' acceptances. It had appointed a secretary at the New York Bank and arranged to have each Federal Reserve bank report weekly by telegram on operations and conditions in its district, and to have a summary of these reports prepared for the benefit of the

committee. The information requested of the Reserve banks included the amounts of bills purchased and rates at which they were purchased, the amount of bills held under sales contracts and the rates at which they were held, rates at which bills were offered by dealers, and comments of dealers and Reserve banks as to the supply of bills and whether or not they were moving freely at the prices offered.

On the basis of these reports, the committee summarized developments in the market between October, 1920 and April, 1921. With about \$1 billion bankers' acceptances outstanding as of October, 1920, there had been a substantial decrease in the volume of new bills and increase in demand. January 1921, was the "high month," with dealers "practically sold out" and "experiencing much difficulty in maintaining their portfolios." The committee also noted "a very marked development in the breadth of distribution." There had been a substantial increase in the number of firms, corporations and individuals holding bills, as well as an increase in the number of member banks holding the acceptances of other banks, and in the number of cities and States in which dealers reported new customers. Further, there was an increase in the amount of foreign funds invested in bankers' acceptances—\$44 million had been invested through the New York Bank alone since September, 1920. These indications that the market was developing as hoped were reflected, the committee noted, in the decline in bills held by the New York Bank. New York had held \$296 million of acceptances on October 30, 1920; \$555 million on January 31, 1921; and \$122,491,000 as of April 1, 1921.

The committee noted that there had been a lack of uniformity in the rates at which bills were purchased during February, 1921, and recommended that "in the absence of special and extraordinary local conditions, the practice of the various Reserve Banks be uniform in this regard." In addition, the committee complained that all the Reserve banks except San Francisco, Minneapolis and New York had a substantial amount of unindorsed bills and that Richmond, Atlanta and Dallas were purchasing directly from acceptors. The committee disapproved of this practice, which "frustrates the efficiency," and recommended "that steps be taken to encourage the sale of bills in well established markets (New York), unless and until they can be better absorbed in the districts where they originate . . . (since) one of the main virtues of bankers' acceptances (is) their relation to the ebb and flow of funds and credit." Finally, the committee reiterated the position on repurchase agreements which had been taken by the New York Bank in March, 1919: in order to develop the market, it was necessary to continue to assist dealers and to guarantee them "a moderate profit." The Reserve banks should not view rates as a primary consideration in arranging repurchase agreements but, rather, should offer dealers the most favorable rate consistent with the minimum buying rate.<sup>19</sup>

At the October, 1921 Conference, the committee reported that the general improvement in credit conditions had been reflected in the open market. Interest rates, which had remained stable despite the sharp fall in prices from May, 1920 to May, 1921, fell in the summer of 1921. The Committee observed that as a result of easing rates, "the markets have depended less and less upon the Federal Reserve Banks

<sup>19</sup> S.E., October, 1921 Conf., pp. 62-70.

for support and accommodation." The committee attributed the fall in rates to the increased amount of foreign funds invested in the New York discount market—about \$300 million—an amount approximately equal to the decreases in bills bought and held by the System since the previous year. This development came about "as the logical result of the position of this country as a creditor nation and a free gold market . . . and the volume of this money seeking employment in the discount market," the committee concluded, "was the first effective urge to lower rates in the market."<sup>20</sup>

This analysis of the fall in rates beginning in the summer of 1921 appears consistent with Governor Case's statement of open market policy objectives: that the System should act only to stabilize and control the market, not dominate it. This position has been restated by the System on subsequent occasions down to more recent times, and has inevitably presented problems in assessing the extent of both its powers and responsibilities in the exercise of control. In this instance, however, there are indications that the lower market rates were not, as suggested, exclusively the result of fortuitous external developments. Clearly weakening credit demand in consequence of the depression was a factor. In addition, substantial purchases of Government securities by the New York Bank appear also to have played some part in easing money rates during the summer and fall of 1921.

Until April, 1921, an aggressive open market policy to lower rates and stimulate economic activity had not been contemplated by Governor Strong. He had advocated rather continuing the pressure for liquidation in the context of the Bagehot doctrine of lending freely at high rates. George W. Norris, Governor of the Federal Reserve Bank of Philadelphia had argued, however, that a reduction in the discount rate "in one or two of the districts other than New York" would do no harm, but that:

. . . the best remedy that can be applied here is an enlarged purchase of bills in the market, so that if the rate on acceptances got down to 5 or 5¼ percent, the member banks that are now buying these bills I think would naturally go into either Treasury certificates or the purchase of commercial paper, and in so far as they went into Treasury certificates it would be helpful to the Treasury and helpful to the market for Government bonds, and helpful to all of us as taxpayers. In so far as it went into commercial paper, it would help every borrower of every commercial bond . . .<sup>21</sup>

By October, Strong had come around to this position publicly, arguing that "you are not going to make money cheaper to the original borrower by reducing your discount rate." Explaining the position and indicating the actions already taken by the New York Bank in implementing it, he said:

. . . I think that it would be of assistance to the business of the country to hasten that process of rate reduction if it is possible to do it, and we have endeavored to do it in New York principally in two ways. One is always to be in the market to buy bills, not in very great volume, but always have the pressure there to put out our money. The second, which is the most effective thing we have, is that the minute the books close on an issue of certificates at the Treasury, we jump right in and buy every certificate that is offered in the market, and put them to a premium.

<sup>20</sup> *Ibid.*, pp. 70-75.

<sup>21</sup> *S.R.*, April, 1921 Conf., p. 34.

You know, when a thing sells at a discount nobody wants it. The minute that it goes to a premium everybody wants it, and there is a little psychological influence made effective by our going into the market the minute the books close on these certificate issues and buying everything that is offered, and that has had a very wholesome effect in getting our rates down in New York, I think.<sup>22</sup>

The fact that the New York Bank undertook to lower rates by means of purchases in the open market at some point between April and October 1921, has often been overlooked. One reason for the oversight is the fact that records of transactions by the Reserve banks during this period are incomplete. Another is that statements by Governor Strong during the summer and fall—other than the statements to the October Conference quoted here and in the previous chapter—are confusing and even misleading.<sup>23</sup>

Perhaps the best example of how Strong's statements on the effects of open market operations on credit markets and interest rates confused the issue is contained in a memorandum dictated by Strong as the basis of a reply to a wheel manufacturer in Ohio, Mr. Russell, who had written the New York Bank suggesting that it purchase \$100 million in Treasury certificates to reduce member bank indebtedness to the Reserve banks and ease the money market. Strong said :

He is right in stating that if we went into the market to buy 100 millions of Treasury certificates or bills or any other sort of investment with conditions as they are at present, it would not result in an expansion or an inflation of credit and currency, but would probably result in the immediate repayment of borrowings for a like amount by the member banks, and would simply convert one kind of Reserve bank investment (loan) into another kind of Reserve Bank investment (certificate of indebtedness or bill). I doubt if it would affect the policy of any member bank in this district in influencing the amounts which it is willing to lend to its customers. . . . The purchase of \$100 million of Treasury certificates would probably not alter the situation as to market rates for money more than very temporarily. What will alter the market rate for money is to have member banks get out of debt with us and begin to compete for loans, because when they owe us money, whenever they have a surplus to loan they are obliged to apply it to reducing their debt to us. . . .

I agree in general that ultimately in more normal times, or I should say possibly "less hectic times," the operations of the Reserve Banks will be principally through open market purchases rather than discounting for member banks.<sup>24</sup>

The argument that rates would only be lowered when member banks began to compete for loans was a repetition of Strong's testimony before the Joint Commission. This memorandum was, moreover, written in October. Professor Chandler concludes from it that, because he failed to note the effect of purchases on member bank indebtedness "Strong did not then understand the subject" of open market opera-

<sup>22</sup> S.R., October, 1921 Conf., pp. 634-637. The action of the New York Bank had the effect intended. During the last four months of 1921, investments in Government securities by reporting member banks increased although loans secured by government obligations decreased. The total increase for 1921 in the government security portfolio for 800 reporting member banks was \$200 million (Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, p. 64).

<sup>23</sup> Compare Governor Strong's statements to the Joint Commission of Agricultural Inquiry in August, 1921 and to the Governors' Conference in October of that year (Chapter IV, footnotes 37 and 43). It should be added that in his statements before the Joint Commission he mentioned open market operations only briefly as follows:

"The Federal Reserve banks do not go into the market and do business direct in lending money, except to the extent that they are permitted to buy bills or acceptances in the open market, and to the extent that they are permitted to deal in all security issues of the United States Government. Therefore, there is no possibility of competition except in those two very limited (sic) fields between the member banks and the reserve bank." (*Agricultural Inquiry, Hearings, 67th Congress, 1st Session, August 8, 1921; Vol. 2, p. 515.*)

<sup>24</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, pp. 207-208.

tions.<sup>25</sup> Chandler apparently has overlooked the discussion during the October, 1921 Conference—roughly contemporaneous with the memorandum. If the Russell memorandum represents a deliberate effort to mislead on Strong's part, it is not the only instance in his career. He always believed, as have many of the System's highest ranking officers down to today, that an understatement of its powers—particularly its power to create easy money—was necessary for the welfare of the System.

Governor Strong has provided the clue as to when the New York Bank's operations in Treasury securities began. In his appearance before the Joint Agricultural Commission on August 8, 1921, he outlined the "symptoms of recovery" as "first . . . a tendency toward easier rates for money," and second, "the immediate influence upon security values." Elaborating on the second point, he said:

If you will look over the quotations of the bonds of the Government you will find that they have all recently advanced. If you examine the tables that I will submit showing the costs now in the market, you will find that every issue that the United States Government has got outstanding is selling at a premium in the market.<sup>26</sup>

While Governor Strong did not acknowledge before the Joint Commission that the New York Bank was buying these issues and putting them to a premium, this description of the condition of the Government securities market resembles the one given the Governors Conference in October and appears to indicate that these conditions were the result of the same policy. Add also, the figures on holdings of Government securities by the Reserve banks which, while incomplete, show a definite increase in 1921 in holdings by the New York Bank.<sup>27</sup> In view of the fact noted earlier that as late as April, 1921 Strong had not yet contemplated an aggressive open market policy, it would appear that the bulk of the buying came in the second half of 1921.

As noted above, the open market committee cited the increase in foreign investment in the New York discount market as the decisive factor in lowering rates. The October report of the committee thus implies that the System had come to play a passive role in the open market. This was the case. The total volume of System investments declined in 1921 and the pattern of operations appears to conform to Governor Morss' recommendation that purchases be made primarily in a Reserve bank's own district to develop the local market.<sup>28</sup> New York's operations in Government securities constituted an aggressive attempt to lower rates and stimulate economic activity. But because New York's allotment proposal had been openly repudiated, it no longer controlled purchases for the System as it had in the pre-war era, and, as compared with the 1919-1920 period, was used less fre-

<sup>25</sup> *Ibid.*, p. 207.

<sup>26</sup> *Agricultural Inquiry*, Vol. 2, p. 509.

<sup>27</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, pp. 338, 343.

The figures on holdings of Government securities by the Federal Reserve banks indicate that total holdings dropped in 1921 as compared with the previous year—from \$287,029,000 on December 31, 1920 to \$233,528,000 on December 31, 1921. There is no information given by months before 1932, but the share held by the New York Bank increased from \$61,184,000 on December 31, 1920 to \$103,525,000 on December 31, 1921. Figures for 1920 and 1921 for the other Reserve banks show reductions of about half or more in their holdings of Government securities except for a slight increase in the holdings of the Atlanta Bank during 1921. The Chicago Bank's investments in Government securities were substantially larger than those of any of the other eleven banks during 1921, but it held only one-fourth the amount held by New York, or \$26,644,000.

<sup>28</sup> See footnote 27 *supra*.

quently as an agent in making purchases for the other Reserve banks in the New York market. The New York Bank was thus unable to shape System operations into as aggressive an instrument for easing credit conditions as it might have wished at this time. Moreover, the standing committee had not been empowered to handle transactions for the Reserve banks and could only suggest buying rates. The result was a considerable degree of autonomy for the individual Reserve bank in the area of open market transactions.

This arrangement appeared to offer no effective means of controlling the market and had not been intended as such. However, the decentralization of transactions demonstrated the extent to which the New York Bank's position and resources enabled it to influence the market without drawing on the resources of the other Reserve banks. With all the Reserve banks operating independently, New York had been able to adopt the more aggressive policy unilaterally. Governor Strong called attention to the impact of New York's policy at a fortuitous moment in that, by October, a majority of Reserve officials had come to favor action to lower rates. Since interest rates had fallen beginning in the summer of 1921, Strong was now able to persuade many of the Reserve bank governors to adopt a more activist policy.

### 3. *The 1922 operations in Government securities: establishment of the Committee on Centralized Execution of Purchases and Sales of Government Securities.*

Beginning in January, 1922, the Federal Reserve banks made substantial purchases of Government securities. They acquired approximately \$365 million between January and June and on June 14, held a total of \$629,000,000. The effect of these purchases on the market caused alarm within the financial community. As Governor Strong had anticipated, any effort by the System to create easy money was bound to be unpopular and to lead to charges that the System had exceeded its authority.<sup>29</sup> Most importantly, the Reserve banks' purchases of Government securities also caused alarm within the Treasury, and it was primarily as a result of the Treasury's pressure that a committee to centralize execution of Reserve bank purchases and sales of Government securities was set up. This committee was the predecessor of the Open Market Investment Committee established in 1923.

Secretary Mellon called the Federal Reserve Board's attention to the volume of Reserve bank purchases and elicited an opinion from its general counsel to the effect that the Board could intervene and impose any restriction it thought necessary. Meanwhile, Secretary Mellon had also requested an opinion from the Federal Advisory Council.<sup>30</sup>

<sup>29</sup> Minutes, July 12, 1922 Meeting of the Committee of Governors on Centralized Control of Purchases and Sales of Government Securities, Federal Reserve Board File 333.a. Wicker, *op. cit.*, p. 67.

Harold L. Reed states that "in 1922, holdings of discounted bills soon came to be exceeded by holdings of securities, with certain embarrassing results"—i.e., "complaints that the Reserve banks were becoming too vigorous competitors of member banks and that the institutions which supply the capital of the Reserve banks were being deprived of earnings because of the depressed money rates which the Reserve Banks had helped to generate. By resolutions at various bankers' conventions and otherwise the member banks began to demand that the Reserve Banks operate less extensively on their own initiative. Later it was insisted in some of these pronouncements that the Reserve Banks should return to their 'original' functions of rediscount and issue and that they should operate more as emergency, panic-allaying institutions." (Reed, *Federal Reserve Policy, 1921-1930*, New York, McGraw-Hill, 1930, p. 28).

<sup>30</sup> Memorandum of April 13, 1922 from Walter S. Logan, General Counsel to the Federal Reserve Board. Letter of April 14, 1922 from Under Secretary of the Treasury S. Parker Gilbert to the Board. Letter of April 25, 1922 from Secretary of the Treasury Mellon to the Federal Advisory Council. FRB File 333.a.

Like the banking community, Mellon favored liquidations and probably anticipated support from the council as the representatives of the member banks. To a certain extent, the Council did support Secretary Mellon's position. A preface to its recommendations "... congratulates the country upon enjoying a financial administration which takes the enlightened view that the Federal Reserve System should not be used for the purpose of carrying the Government's obligations..." It agreed with the Treasury that "excessive" investments in Government securities should be avoided, and that, as a general policy, investments in bankers' acceptances were preferable. However, the Council thought that the high reserve ratios of the Reserve banks justified their actions to some extent, and argued:

Moreover, if the Federal Reserve Banks should entirely liquidate their holdings of Government obligations, they would thereby lose all power of influence on the banking situation of the country, in case excessive ease of money should develop, threatening a new era of inflation. In such times, it is of the utmost importance that the Federal Reserve System should be able to dispose of its holdings, thereby throwing the burden on the member banks and thus exercising a restraining influence.<sup>31</sup>

The Council's reply is significant in that it indicates the breadth of theoretical revision in the System. It is evident that Government securities now were no longer viewed as an inappropriate investment for the Reserve banks or their member banks, and that the experience of the previous year had demonstrated that the volume of Government securities held in the banking system was not an automatic gauge of credit inflation. The Council recommended that the Reserve banks resolve their difficulties with the Treasury by confining their purchases to short-term Government obligations and by taking care to schedule purchases so as not to interfere with Treasury operations. Secretary Mellon pressed the matter further, requesting a discussion of the topic and of the Council's recommendations at the May 2 Conference of Governors. The governors reacted defensively. Except for Governor Strong, they all reported that they had purchased Government securities "for income purposes," and the Chicago Bank had bought only from its own member banks or local dealers. As for the choice of Government securities as investments, Governor Calkins noted that they had been bought "because acceptances are practically unobtainable at the present time."<sup>32</sup>

Governor Strong argued, though somewhat obliquely, for Federal Reserve transactions in Government securities on economic grounds. The Secretary's summary reports that he:

... called attention to the fact that the Federal Reserve Bank of New York has made investments of approximately \$195,000,000 in Government obligations, and that while one of the purposes was to assist in meeting expenses, nevertheless one of the chief purposes was to have on hand investments which would enable the bank to exert control on the money market if it should become necessary to do that without an increase in the discount rate...<sup>33</sup>

In a subsequent statement, Governor Strong stated the case more positively when he observed that the relationship between these purchases and the declining interest rates was not accidental and that had the Reserve banks not increased their investments, "recovery of business would have been somewhat slower":

<sup>31</sup> April 23, 1922 Recommendations of the Federal Advisory Council, FRB File 333.a.

<sup>32</sup> *S.R.*, May, 1922 Conf., pp. 7-10.

<sup>33</sup> *Summary*, May, 1922 Conf., p. 10.

My belief is that the policy of the system in reducing rates and in keeping this amount of funds available to the country—this is only an opinion—has been one of the influences that has hastened and facilitated the recovery of business that has taken place.<sup>34</sup>

The possibility that other Reserve bank governors had undertaken purchases of Government securities to influence rates downward is implied in Governor Strong's statement. As noted earlier in the chapter, he had already made such a suggestion in October, 1921 and the response of the governors of the Kansas City and Dallas Banks at that time indicates that they and the other governors were at least aware of what effect any future investments might have. The lack of coordination among the Reserve banks in buying these securities made it appear that they had no basis in policy. However, as Governor Morss observed, a more accurate description would be the absence of "any acknowledged policy."<sup>35</sup>

Meanwhile, the fact that Secretary Mellon should be the one to press charges in this matter came as a surprise to most of the governors. As Governor Seay noted, the situation had been "an advantage and blessing to the Treasury," which was indebted to the Reserve banks "for its ability to operate as successfully as it has . . ." The Treasury, however, thought that it had been harmed rather than helped; that, as Governor Strong explained, Reserve bank operations had frequently coincided and interfered with Treasury operations, that they were frequently outbid, and that the Reserve banks had pushed up the price of Treasury issues and established an interest basis which did not "represent a true market condition." Should the Reserve banks then discontinue buying, and the securities return to "their natural rate," Strong said:

. . . somebody is going to say what under the Heavens has happened to the market? The certificate market has gone to smithereens. It is just inviting trouble.<sup>36</sup>

As the Federal Advisory Council had noted with approval, Secretary Mellon did not believe it was the function of the System to support the Government bond market. The System had continued to support the bill market, nonetheless, and the report of the standing committee to the May, 1922 Conference noted that the Reserve banks "generally have operated to give effective stability to existing market rates." The Chicago bank acknowledged that it had applied the same principles in seeking to develop a similar market for Government securities in its district, and indicated that it was prepared to continue operations in Government securities on that basis, acting to stabilize rates.<sup>37</sup>

The System's efforts to support the bill market had been opposed by the Treasury in 1919 and 1920, but there had been no attempt to prevent support buying. Since there was no precedent for this kind of intervention in Reserve bank operations, Secretary Mellon's right to request that the Reserve banks restrict their investments in Government securities was questioned. The governors resented the Treasury's complaint that their purchases had interfered with its operations since it had never contacted the Reserve banks to let them know when it was

<sup>34</sup> *S.R.*, May, 1922 Conf., pp. 133-134.

<sup>35</sup> *Ibid.*, p. 528.

<sup>36</sup> *Ibid.*, pp. 109, 128, 521.

<sup>37</sup> *Ibid.*, pp. 511-512, 543.

in the market for securities. A discussion of their rights in making open market purchases was interrupted by Governor Strong, who advised that:

. . . the wisest thing is to find the solution and not to fall back right away upon the question of what your rights are. If we adopt that policy, our relations with the Treasury are certainly going to be of a very unsatisfactory character.

Moreover, Governor Strong argued, the law required the Federal Reserve banks to serve the Treasury in fiscal matters. Should they refuse to accommodate the Secretary, he could appeal to the President or to the Congress, and the matter might go to the extreme of "removing some people from office." Strong's sensitivity to the System's function as fiscal agent is reflected in the volume of transactions which the New York Bank handled for the Treasury. Governor Morss had also concluded that "we had no rights . . . that everything was subservient to that part of the law which says that the Secretary may require the Federal Reserve banks to act as fiscal agents." The discussion ended with the following exchange:

The CHAIRMAN (Strong). . . . What I want to bring strongly to the attention of this Conference is this: that the Secretary of the Treasury feels that he is entitled to not only certain services, but to certain general cooperation in policy, and as long as Secretary Mellon feels that he may not be getting that, it would be exceedingly difficult for us to adjust our relations with the Treasury.

Governor MILLER. He should tell us his policy so that we would know how to adjust our transactions.<sup>38</sup>

The policy which the Treasury favored was as follows: investments in Government obligations were to be limited to the amount needed to provide sufficient earnings to meet expenses; current "excessive" investments were to be permitted to mature without replacement.<sup>39</sup> The problem of the large gold reserve and the fact that it offered a justification for Reserve bank investments had been anticipated by the Treasury. The governors were advised that they would be requested to make certain disbursements in gold in making payments for the account of the Treasurer, and that an informal understanding existed between the Federal Reserve Bank of New York and the Treasury Department which "obviated any necessity of discussing this matter formally in conference, or of trying to define the strict legal rights of the Treasury or the Federal Reserve Banks in reference to payments for the Treasurer's account."<sup>40</sup>

It is clear that Secretary Mellon and Governor Strong had come to some understanding on the larger issues as well. Not only had Strong presented the Treasury's case, he had pressed the governors to accept it. The recommendations of the Treasury were formally adopted by the Conference with the reservation that there be no limit on transactions between the Reserve banks and their member banks. However, the "hub of the thing," as Strong put it, was:

. . . can reserve banks agree upon some method of placing an executing order, both buying and selling, that will relieve the market, if you please, of the appearance of orders occurring at the same time, and in such a way that it will not create an artificial market and not interfere with the Treasury.

<sup>38</sup> *Ibid.*, pp. 119-122, 128-129, 513-516, 525.

<sup>39</sup> *Ibid.*, pp. 15, 535-537.

<sup>40</sup> *Summary*, May, 1922 Conf., pp. 25-26.

After considerable discussion, guided by Strong is one of his better efforts with the socratic method, the answer was provided by the governor who had required the most prodding, Norris of Philadelphia:

There are only two practical ways to reaching the result. One is by a centralized joint buying and selling agency, and the other is by a periodical agreement on prices.<sup>41</sup>

At the suggestion of Governor Strong, a motion was offered and adopted which referred the matter of working out an orderly method of executing orders to buy and sell Government securities to the governors of the Boston, New York, Philadelphia and Chicago Federal Reserve Banks. (On the Committee's recommendation, the Governor of the Cleveland Bank was added during the October, 1922 Conference.) The stated purpose of the committee was to avoid the effects of competition among the Reserve banks on the market by coordinating purchases. However, Governor Strong added a deeper dimension with the suggestion that the committee consider "what is a wise investment policy for the Reserve System and to what extent can we afford to pump credit into the market?"<sup>42</sup>

At an earlier point during this same Conference—in May, 1922—Strong had attempted to lead the governors into a discussion of the relationship between open market operations and policy objectives during deliberations on the discount rate. A majority of the governors opposed rate reductions because they were opposed by the member banks and because, as Governor Morss noted, "we may have a kind of boom on our hands in regard to the commodity prices . . . and we do not want to do anything to encourage it." Governor Strong replied:

Governor Morss, don't you recognize that we have greater power to induce such a development by our open market operations than we have by a discount rate?

Governor Morss replied:

Well, they are two operations that work together. If you buy in the open market and then reduce your rate, it is simply increasing the momentum of it. On the other hand, if you do not reduce your rate it seems to me that tends to offset what you do in the open market.<sup>43</sup>

Perhaps because, as Governor Morss' reply indicates, the majority of Reserve officials did not fully understand the power of open market operations, they were not wholly committed to it as a policy tool or altogether committed to an interventionist policy. As the decade advanced, it became increasingly clear that their primary concern was for the level of interest rates and that frequently they favored discount rate policies which, as Governor Morss termed it, "offset" the value of open market operations.

The position of the Governors during the May, 1922 Conference reflected the latter view. They opposed any drastic liquidations of their investments because they feared the effects on their earning positions. They were prepared to let their investments run off without replacement to levels which were sufficient to cover expenses, but not to sell in the market as a means of raising interest rates. The Conference concluded without any definite consensus on policy objectives. To a certain extent the burden for devising an investment policy was left to the

<sup>41</sup> *S.R.*, May, 1922 Conf., pp. 537-543.

<sup>42</sup> *Ibid.*, pp. 550-551, 115-116.

<sup>43</sup> *Ibid.*, pp. 155-156.

individual Reserve bank with the committee empowered only to advise on policy. However, with the focus on investments for earnings, the committee's scope was limited.

The new committee—titled the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities by Federal Reserve Banks—met for the first time on May 16, 1922. Although Strong was absent, he was made permanent chairman and a permanent secretary was appointed to be the active agent in handling transactions for the committee. The committee agreed that it should handle all purchases and sales for the Reserve banks and should be careful not to make its transactions in a single market but, rather, with a view to developing local markets in each Federal Reserve district. In addition, it requested a detailed statement on the amount and character of Government securities held by the Reserve banks and estimates of their expenses and earnings. The Minutes reveal a recognition on the part of the committee that its powers were limited to handling transactions and making policy recommendations to the Reserve banks. Actual orders for securities were to originate with the individual Reserve banks.<sup>44</sup>

Between May 16 and June 30, 1922, the System's holdings of Government securities were reduced by about \$55,000,000. At the July 12 meeting of the committee, the Governors agreed to the Treasury's request that the Reserve bank's holdings of certificates maturing August 1 be allowed to run off. As of September 20, holdings were further reduced by about \$168,000,000 from the high point of \$629,000,000 on June 14, 1922. Of the \$168 million, approximately \$130 million of Treasury certificates and notes actually matured. As the committee's report to the October 10 Conference of Governors noted, it was "therefore evident that the Federal Reserve Board's suggestion, that all banks allow their investments to run off without replacement, has been generally followed."<sup>45</sup>

There were no meetings of the Committee between July and October, during which time the market remained easy. The New York and Boston Banks had reduced their discount rates to 4 percent during the latter part of June, the San Francisco Bank's rate was also lowered to 4 percent on July 8, Dallas' rate dropped from 5 to 4½ percent on July 12, and the Minneapolis and Kansas City Banks dropped their rates to 4½ percent in mid-August. In September, the Treasury resumed its pressure for liquidations, addressing its communications to the Federal Reserve Board. The Board again approached the Federal Advisory Council, requesting that it consider whether or not there should be "any change in the policy of the Federal Reserve Banks carrying considerable investments in United States Government securities." The Council replied that it saw no need to change its earlier recommendation and reiterated that Reserve bank purchases of Government obligations should not be governed by the necessity of covering expenses, and that "open market operations, particularly in so far as

<sup>44</sup> Minutes, May 16, 1922 Meeting of the Committee of Governors on Centralized Control of Purchases and Sales of Government Securities by Federal Reserve Banks, FRB File 333.-a. (Note: the word "control" in the title of the Committee was changed to "execution" at some point before submission of the Committee report to the October, 1922 Conference of Governors).

<sup>45</sup> Minutes, July 12, 1922 Meeting of the Committee of Governors on Centralized Control of Purchases and Sales of Government Securities; Report of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities, October 10, 1922; FRB File 333.-a.

they touch investment in government securities, should be carried on under a uniform policy by the System as a whole." In addition, the Council noted that it had "learned with great satisfaction, of the organization of a committee of Governors having supervision of transactions in government securities by the Federal Reserve Banks." On the question of further liquidations, the Council equivocated. It recommended that "the policy of the Federal Reserve System as a whole, should be, at this time, not to increase any further its investments in Government securities."<sup>46</sup>

When the Committee met on October 2, 1922, its first order of business was consideration of the Council's recommendation. It voted to concur in the recommendation with the addition of the following views for submission to the Governor's Conference on October 10:

Upon reviewing the investment operations of the Federal Reserve Banks during the year 1922 the Committee believes that there will be no dissent to the proposition that in purchasing Government securities too much attention must not be given to the consideration of earnings and dividends. Due to the fact that liquidation was still in process and that the money market was easy, with low rates, apparently no particular harm has resulted from these operations during the first half of the year. During the second half of the year the situation has changed and with that change there has arisen a need for a different policy, the belief being that increased attention must be paid by the System to the bearing of the investment operations of the Federal Reserve Banks upon the money market.

Given the policy recommendation, the Committee then asked the Conference for increased authority to have its "recommendations . . . receive serious consideration by the officers or directors of the several banks," "in every case," and for a free hand in advising and handling both purchases and sales. When these recommendations were presented to the Governor's Conference, one of the members of the committee itself—Governor McDougal of Chicago—voiced disapproval of "any radical changes," of the sort suggested in the recommendation that the operations in Government securities be confined "exclusively to the course of the money market as a factor."<sup>47</sup>

Explaining the Committee's recommendation, with Under Secretary of the Treasury Gilbert present, Governor Strong appeared somewhat defensive. He admitted that it implied that the committee would be "reaching into the policy of the banks which, heretofore, (it) has not attempted to do," but argued that it did not mean that the committee would, "interfere in any way with the decision of the directors." In any event, Governor Strong observed, should the other Reserve banks decline to accept the recommendations of the committee, "the five banks that are represented on the committee, would be, in point of fact, such a large preponderant proportion of the whole system that it would have considerable influence alone, just those five banks."<sup>48</sup>

Under Secretary Gilbert's remarks to the Conference indicated that the Treasury might well support the Committee's request for an enlargement of authority, but would continue to impose its own interpretation of policy objectives. Mr. Gilbert said:

The Centralizing Committee appointed at the last Conference has been of the greatest assistance in keeping the situation steady, and has accomplished a con-

<sup>46</sup> September 26, 1922 Recommendations of the Federal Advisory Council, FRB File 333.-a.

<sup>47</sup> Minutes, October 2, 1922 Meeting, and October 10, 1922 Report of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities, FRB File 333.a. S.R., October, 1922 Conf., p. 4.

<sup>48</sup> S.R., October, 1922, Conf., pp. 433-434.

siderable liquidation. The tightening of money that comes every time there is a little further liquidation, was particularly in evidence after the September 15th maturities, and it had a good deal to do with the tightening of money in the latter half of September, as we see it here in the Treasury. I am hopeful that the success of this long term offer of bonds will help to clear up the short term market and put it in so much better shape that it will be possible to accomplish gradually further liquidation of Federal Reserve bank investments without disturbing Treasury operations in the next few months. The next few months, of course, will involve as heavy operations as we have had since the period following the Victory Loan, and we are going to look more to the committee than ever to keep purchases and sales of Federal Reserve banks from giving us a false market either way, and I have every reason to believe that the Committee will succeed in doing that, as it has done for the last few months.<sup>49</sup>

The point of Under Secretary Gilbert's remarks was the reference to further liquidations. On October 17, the Treasury advised the committee that it wished to purchase for redemption the approximately \$33,015,000 of December 15 certificates held by the New York Bank, and on October 24, suggested that the committee recommend that the other Reserve banks make their holdings of this maturity available for purchase by the Treasury. As of October 25, the System's holdings had been reduced to about \$408,000,000 and by January 31, 1923, had been further reduced to about \$353,000,000 of which \$82,000,000 were Treasury certificates maturing March 15 which the Treasury proposed to take over, and \$33,000,000 were held under repurchase agreements. As these figures indicate, the committee functioned more or less as a channel between the Treasury and the holdings of the individual Reserve banks; there were no substantial executions of purchase or sales in the open market. Nevertheless, the liquidations appear to have made a significant impact on the market. During the week of October 31, 1922, for instance, Liberty bonds sold off the stock exchange with a net loss of about 32 cents per hundred for each issue while Treasury certificates and notes were traded in at fractionally lower prices.<sup>50</sup> By contrast, the System's continued support had preserved a remarkable degree of stability in the market for bankers' acceptances, and an increase in purchases of bills and other securities of approximately \$173 million offset reductions in Government bond holdings.<sup>51</sup>

The Standing Committee on Open Bill Market Conditions was still in existence at this point and had reported to both the May and October 1922 Conferences. In May their holdings represented about 15 to 20 percent of the total volume of bills outstanding, including bills held under repurchase agreements, and their confidence in their ability to control the bill market was such that they had recommended against permitting rates to ease downward to compete with rates in the London market, and advised that the current rate of  $3\frac{3}{8}$  percent be maintained for the time being. The October Report also noted that, in response to the higher levels for Treasury certificates in the latter half of August, it had become necessary to advance the rate on bankers' acceptances in order to dispose of the bills. Therefore:

<sup>49</sup> *Ibid.*, pp. 435-436.

<sup>50</sup> Minutes, October 31, 1922 Meeting, and Report, February 5, 1923 of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities, FRB File 333-a.

<sup>51</sup> Wicker, *op. cit.*, p. 71.

... Federal Reserve banks, in assisting the market to higher levels, acquired substantial increases in their bill portfolios but operated in such a way as to avoid making drastic advances necessary at any one time, permitting the dealers and discount houses to continue to accommodate the new bills coming to the market at gradually advancing rates without unwieldy increases in their own portfolios.

The committee recommended that for the time being the Reserve banks should not attempt to depress the rates for bills by either increasing their portfolios or supporting an "artificially" low rate, nor "allow rates to advance disproportionately to rates for commercial paper and Treasury Certificates." but, rather, should "continue to assist and support the market to and at . . . reasonable levels of rates. . ." <sup>52</sup>

#### 4. *Creation of the Open Market Investment Committee: 1923*

At the February 5, 1923 meeting of the Committee of Governors on Centralized Execution of Purchases and Sales, the governors reviewed the October, 1922 policy directive. It had been agreed that the System should "furnish credit and currency to member banks for their seasonal and emergency requirements," but that open market operations should be administered "in such manner as to assist the system in discharging . . . its national responsibility to prevent credit expansion from developing into credit inflation." The Committee voted to continue the present policy, equalizing current holdings of Government securities among the Reserve banks "without putting further Federal Reserve funds into the market through open market operations." <sup>53</sup>

The policy of restraint was executed by means of further liquidations of Government securities from the portfolios of the Reserve Banks. Between June 14, 1922 and February 1, 1923 the Reserve banks liquidated \$276 million Government securities and market rates rose to about 1 percent above New York's discount rate. Therefore, on February 23, the New York and Boston Banks raised their rates from 4 to 4½ percent with San Francisco following on March 6. This action brought the rate at these three banks in line with the other Reserve banks and the uniform 4½ percent rate prevailed at all 12 banks until the middle of 1924. <sup>54</sup>

At this time, however, in February, 1923, Reserve bank demands for earning assets to meet expenses came into conflict with the policy of restraint. The Committee attempted to meet Reserve bank needs by reapportioning investments but found that in order to meet all demands, it would have to make some purchases in the open market. Meanwhile, one of the Reserve banks by-passed the Committee and bought about \$2 million of Government certificates. These events elicited an immediate reaction from Secretary Mellon. On March 10 he wrote the Board:

It is hardly necessary to point out that purchases of Government securities by the Federal Reserve Banks put Federal Reserve funds into the market, thereby increasing the supply of available funds, and that it is destructive of any credit policy which the Federal Reserve System may be pursuing to permit the Federal Reserve Banks to expand credit in this way simply for the purpose of increasing their own earnings and putting themselves in a position to pay expenses and

<sup>52</sup> S.R., May, 1922 Conf., pp. 511-512. S.R., October, 1922 Conf., pp. 322-324.

<sup>53</sup> Minutes, February 5, 1923 Meeting of Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities, FRB File 333.a.

<sup>54</sup> February 5, 1923 Report of Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities, FRB File 333.a. Wicker, *op. cit.*, p. 72. *Banking and Monetary Statistics*, p. 440.

dividends. Such an attitude on the part of the Federal Reserve Banks subordinates the major question of credit policy to a purely incidental question of Federal Reserve Bank housekeeping . . . It seems to me clearly necessary, therefore, that the Federal Reserve Board, acting under its general powers, should prescribe regulations governing the open market operations of the Federal Reserve Banks, and require in these regulations that the Federal Reserve Banks shall not make any further purchases of Government securities, or bills, for the purpose of increasing their earning assets without first getting the express approval of the Federal Reserve Board, and that generally speaking the Federal Reserve Banks shall not in the future make investments simply for the purpose of increasing earning assets. It should also be definitely understood that under any circumstances all purchases and sales of Government securities for account of the Federal Reserve Banks are to be handled through the Central Committee of Governors which is now functioning.

As for current policy, Secretary Mellon added that "with rising interest and discount rates the Federal Reserve Banks ought to be endeavoring to liquidate the investments they already have rather than to accumulate larger holdings."<sup>55</sup>

The Vice Governor of the Board, Edmund Platt, responded to Mellon's letter by appointing a committee to prepare regulations governing open market operations. The outcome was a resolution—apparently drafted by Adolph Miller—which dissolved the Committee of Governors on Centralized Execution of Purchases and Sales and authorized the formation of a new committee, entitled the Open Market Investment Committee. Since there was to be no change in its composition—the same five Reserve bank governors being designated as members—the purpose of the resolution was to provide a new mandate for the committee and to clarify the Board's authority over these transactions. Thus, open market operations were to be handled by the Open Market Investment Committee under the Board's supervision in accordance with the following principles:

(1) That the time, manner, character and volume of open market investments purchased by Federal Reserve Banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation.

(2) That in making the selection of open market purchases, careful regard be always given to the bearing of purchases of United States Government securities, especially the short-dated issues, upon the market for such securities, and that open market purchases be primarily commercial investments, except that Treasury certificates be dealt in as at present, under so-called "repurchase" agreement.<sup>56</sup>

<sup>55</sup> Letter from Secretary of the Treasury Andrew W. Mellon to the Federal Reserve Board, March 10, 1923, FRB File 333.b.

In a subsequent letter to Vice Governor Platt, Mellon noted that:

" . . . There are, of course, many legitimate transactions in connection with which the Federal Reserve Banks may buy or sell Government securities, on repurchase agreements or otherwise, and these transactions should not, of course, be hampered by regulations any more than is absolutely necessary." (Letter, March 15, 1923, FRB File 333.b).

Mellon's support on this issue subsequently enabled the Committee to block a motion offered by Adolf Miller in the early months of 1925, to outlaw repurchase agreements. (Correspondence between Under Secretary of the Treasury Garrard B. Winston and President of the Federal Advisory Council Paul M. Warburg, February 12-13, 1925, Mellon Files, National Archives).

Another issue in which Mellon's support was crucial in enlarging the function of the Committee is foreshadowed in the March 10 letter. Mellon recommends that the Reserve banks not be permitted to buy Government securities, or bills, without the "express approval of the Board." Undoubtedly he was aware of the effects of the substantial purchases of acceptances in the latter part of 1922. (See previous section of text and footnotes 51 and 52.) At the Governors' Conference later in the month, Under Secretary of the Treasury Gilbert said:

"The Treasury has no immediate concern with the question of acceptances, but from what we do see of it, it is so clear that they are interrelated with the dealings in Government securities on the market, that I should say it would be an excellent plan to have them combine with the committee dealing with open market operations." (*S.R.*, March, 1923 Conf., p. 741).

<sup>56</sup> Resolution adopted by the Federal Reserve Board, March 22, 1923 (Board Memorandum X-3675), FRB File 333.a.S.R., March, 1923 Conf., pp. 16-23.

The resolution was presented to the Governors Conference at the end of March, 1923 and was immediately challenged by the Governors of the Boston, Philadelphia, Chicago and San Francisco Banks. W. P. G. Harding, formerly the Governor of the Federal Reserve Board who had succeeded Charles A. Morss as governor of the Boston Bank, questioned the Board's power in this area; but, as his statement makes clear, he was as much concerned with the Treasury's right to intervene:

I want to stress two points. It is very doubtful, at least in my mind, whether the Federal Reserve Board has specific power to fix a definite limit as to the amount of these legitimate open market transactions that a Federal Reserve bank may engage in. They have the right to regulate it, but nowhere in this act is the Treasury Department of the United States charged with that responsibility for the credit policy for the Federal Reserve Bank; nowhere in the Act is the Treasury vested with the power to limit arbitrarily the purchase by Federal Banks of notes and bonds of the United States, and nowhere is the Federal Reserve Board given specific power to limit the amount of bonds and notes of the United States that the board of directors of the Federal Reserve banks may wish to buy.<sup>57</sup>

Governor Norris raised another point. If the Board had the authority to limit and otherwise determine the securities purchased by the Reserve Banks, "then instead of having a regional system of reserve banks we would have a central bank with the Federal Reserve Board as that bank." In view of its 1921 disclaimer of any central banking power—promoted largely by himself and Secretary Mellon—Governor Harding noted that the Board would have to reverse itself on the subject of its own powers. Governor McDougal warned that the committee itself would constitute a threat to the "independence of action" of the Reserve banks. He wanted "a committee of an advisory nature, not one of control" and proposed that its authority to control the volume of transactions be deleted from the resolution.<sup>58</sup>

Adolph Miller's reply to these objections was that, "if the Board has not the clear right, the Board's first duty is to get it." He gave the following reasons why:

. . . I regret to say there has even been some question in the Board itself as to whether it had the power. A board that doubts its power doubts its responsibility, and a board that doubts its responsibility is very apt to be charged with responsibility later on so that it seems to be desirable to know on just what basis we are standing in this matter. I think we have got the power; to me it is almost as clear as though it were there . . . What we have been short on in the Federal Reserve System and what we are still short on, is some agency for the formulation and development of policy . . .

. . . and I become more and more of the opinion that the open market operations of the system are going to be the most important part of the system, largely because it is through the open market clause of the Act that the reserve banks are in a position to take the initiative; the bank doesn't have to sit back and wait until somebody comes to it, but it is in a position to go ahead and absorb funds for its purposes, when it desires to do so.<sup>59</sup>

Meanwhile, Under Secretary Gilbert explained the Treasury's position:

. . . I doubt if there is very much to be gained by a discussion of the question of power. It seems to be very clear in the express words of the Act that the Board has power to proscribe rules and regulations, and I should think that this expression of policy was a fully authorized expression of policy on the part of the Board. On the question of policy the Treasury is heartily in favor of the declara-

<sup>57</sup> S. R., March, 1923 Conf., pp. 679-680.

<sup>58</sup> *Ibid.*, pp. 705, 708, 724-726.

<sup>59</sup> *Ibid.*, pp. 694, 699-702.

tion embodied in this statement. Furthermore, the Treasury thinks that the Central Committee, which has operated now for about a year has had a most wholesome influence, and that its actions have been most helpful both to the Treasury and to the general situation. There has been a liquidation of something over three hundred million dollars in holdings of Government securities, and regardless of what we may think about the original action of the banks in buying this extraordinarily large volume of Government securities without reference to the Board or to the Treasury, I think there is no disagreement that the subsequent steps which have been taken have been effective and helpful all around.

Mr. Gilbert made no reference to the question of the Treasury's right to intervene in matters of policy; on the contrary, the assumption of this right was implicit in his remarks on the function of the new committee and its policy for the immediate future:

The previous committee of Governors having been superseded by this new Committee on Open Market Operations, the Treasury is hopeful that the Governors, working through that committee, will be able to make further material progress in liquidation . . . we would be very glad to see a considerably further liquidation particularly of the holdings of certificates . . . rather than of notes. I hope you will keep that in mind. Our relations with the previous committee have been most cordial, and we are looking forward to the same cooperation with the present committee.<sup>60</sup>

It is instructive to note here that the Treasury's position in this episode stands out in sharp contrast to the role which, today, it is widely believed the Treasury would play in monetary policy were the Federal Reserve deprived of its independence and made subordinate to the Treasury and President. The prevailing belief is that the Treasury (and presumably therefore the President) desires, above all, low interest rates. Thus inflationary expansion of money and credit would be certain to follow if monetary policy were formulated by the Treasury or others responsible to the President. The events of 1923, when the Treasury favored monetary restraint and put pressure on the Federal Reserve to liquidate holdings of Government securities, contradict this so often asserted scenario.

The Treasury's success in imposing its policy of liquidations on the System was due as much to the cooperation of the New York Bank as to that of the Board. Deputy Governor Case explained New York's position:

. . . So far as I know the present committee . . . has worked very smoothly and very satisfactorily as far as the Treasury and the Federal Reserve Board and the banks combined are concerned. I have not heard any criticism of it. On the other hand, I have heard a number of favorable comments about it.<sup>61</sup>

<sup>60</sup> *Ibid.*, pp. 740-742.

<sup>61</sup> *Ibid.*, p. 685.

Deputy Governor Case's description of the Committee's action is also interesting: "It should not be lost sight of that when that committee was appointed it was desired to bring about a gradual reduction in the holdings, the rather large holdings of Government securities in Federal Reserve banks. So far as New York is concerned, it is understood that the Treasury did not look with favor upon the bank holding so large an amount and we, in common with all the other Federal Reserve banks, have worked towards a gradual reduction of our holdings, so that today we have disposed of all of our Government securities with the exception of ten million dollars of Treasury notes. . . . When the committee was appointed last May there were Government investments in the Federal Reserve banks aggregating roughly five hundred and sixty or five hundred and seventy million dollars. At the present time, after deducting the June 15th certificate, which I think has just been taken up, I think the total holdings are now approximately two hundred and thirty million; so that you see the committee has worked very harmoniously and very smoothly and has been instrumental in stabilizing conditions, and of recent months any transaction that the Federal Reserve banks have had have not been in the open market, but between the Federal Reserve banks. New York has been very glad to sell to other Federal Reserve banks during recent months several millions in short term certificates." (*Ibid.*, p. 686).

As this statement indicates, there was no conflict at this time between the New York Bank and the Treasury. While the other governors were as opposed to liquidation as they were to the idea of intervention by the Board and Treasury, New York had been content to follow a policy of mild restraint and to use sales of investments to offset gold inflows.<sup>62</sup> The Board had cooperated with the Treasury as well but its spokesman, Dr. Miller, was more concerned with the potential value of open market operations as a tool of policy than with the current policy objective. Miller's concern with the question of authority was, however, the crucial issue. The governors had argued that the Board's attempt to clarify its powers by means of a resolution was a distortion of its authority to supervise; that it constituted an assumption of legislative powers.<sup>63</sup> Nevertheless, the Board chose not to ask for clarification of its authority from Congress and, as far as the governors were concerned, its authority to control purchases and sales of investments for the System remained open to question.

##### 5. *The October 1922 symposium on credit policy*

The October 10, 1922 Conference was a unique event in economic history. The Federal Reserve Board had sent a memorandum to the Reserve bank governors and Federal Reserve agents in September indicating that it wished to set aside a portion of the conference for a "comprehensive" discussion of Federal Reserve credit policy. Four topics were chosen for analysis in both written statements to be prepared and circulated before the Conference, and in discussion. The topics dealt with the objectives of credit policy, the relative importance of various factors in determining policy, methods of making credit and discount policies effective, and methods of formulating and implementing policy.

Some of the material produced for this conference found expression in the well-known *Tenth Annual Report of the Federal Reserve Board*, written during the following year. The *Report* has been widely admired for the sophistication of its analysis since J. M. Keynes first took note of it in 1924.<sup>64</sup> The Conference, although it seems to have been overlooked by most analysts, represents a truer picture of views across the System and is important in assessing the behavior of the System during both the 1920's and the early years of the depression. Given the wide divergence of opinion expressed during the Conference, it may be argued that the *Report* is misleading as an indication of the full spectrum of attitudes in the System and its guides for policy. It necessarily rejects the views of at least half of its officials on any given subject. Most analysts assume that the *Report* was written by the Board's staff and reflects the views of the Board. The record of the Conference—presented here in an appendix together with the relevant section of the *Tenth Annual Report*—would appear to support this view with the qualification that the Board's position tends to reflect a selection from the Conference material rather than a unilateral effort by the Board to enunciate an official position for the System.

The *Tenth Annual Report* states that experience had indicated that the System could not exercise its function of "fixing rates with a view

<sup>62</sup> Chandler, *op. cit.*, p. 218. Wicker, *op. cit.*, p. 71.

<sup>63</sup> S.E., March, 1923 Conf., pp. 673-674, 683-684, 702-705, 737-738.

<sup>64</sup> J. M. Keynes, *Monetary Reform*, New York, Harcourt, Brace and Co., 1924, pp. 214-215.

of accommodating commerce and business by the simple expedient of any fixed rule or mechanical principle," and that the System must rely on "judgment" as a guide for credit policy.<sup>65</sup> The position is based directly on Governor George W. Norris' statement that "changes must always be the expression of a judgment, and no absolute formula can be devised."<sup>66</sup> This view was, however, highly controversial and was attacked by Governor Norris' own board chairman, R. L. Austin, who argued that it was an obligation of the System to "remove from our rate making the element of the lack of principle."<sup>67</sup> The debate over whether to use rules or discretion in formulating monetary policy is still unsettled. In recent years it has centered on proposals to increase the money supply 2-4 or 2-6 percent per year. But the advocates of discretion prevail today as they did in 1923.

The Conference also reveals the reluctance of a majority of Reserve officials to abandon the framework of the real bills doctrine. On the other hand there are indications that earlier attitudes had been modified by the recognition of greater responsibility for economic events. Governor Norris' statement—that "the prevention of disaster, and not succor following disaster, is the goal of a successful credit policy"<sup>68</sup>—appears to reflect a majority view as well as the view expressed subsequently in the *Report*. But the concern for economic events was not put into specific form. Thus with Governor Norris concurring, the *Report* explicitly rejects price levels as a guide for policy. Meanwhile, the statements of both Pierre Jay and Benjamin Strong stress the significance of the relationship between price levels and credit policy. In one of the most significant statements on record during the period, Strong said:

. . . Of the various causes of price changes, none is so potent as changes in the volume of "money," that is of credit and currency.<sup>69</sup>

This last statement indicates a level of sophistication beyond that expressed in the *Tenth Annual Report*. As Wicker has observed, the *Report* is concerned with credit, not money.<sup>70</sup> But, again, the significance of the Conference material lies in its presentation of the full spectrum rather than only the official views of the System, and indicates the extent to which shifts in personnel or influence during the decade which followed were factors in shaping its response to events.

<sup>65</sup> *Tenth Annual Report of the Federal Reserve Board (1933)*, pp. 8, 32.

<sup>66</sup> See Appendix A, p. 158.

<sup>67</sup> *Ibid.*, pp. 163-66.

<sup>68</sup> *Ibid.*, p. 158.

<sup>69</sup> *Ibid.*, pp. 161-62, 167-68.

<sup>70</sup> Wicker, *op. cit.*, p. 76.

## PART II

### MONETARY POLICY: 1923-33

#### INTRODUCTION: CONCEPTS OF STABILITY, 1923-28

The behavior of the stock market during the 1920's has made a lasting impression on our cultural as well as economic history and a more substantial reminder of the economic events of this period, evidence of the building boom, is still visible in our cities, suburbs and resorts. The decade began with the most precipitous recession in American history—one which an outraged public was unwilling to accept as a "necessary adjustment" in a boom and bust frame of reference. Two milder declines followed—in 1923-24 and 1926-27—which raised no great outcry. The Federal Reserve System took the position that, while these were also periods of necessary adjustment, it had the means to moderate their effects. Its success has traditionally been measured in terms of the behavior of prices during the period from 1923 to 1928, and has led observers to conclude that it was actually a decade of remarkable stability as well as prosperity.

As announced in the 1920 campaign<sup>1</sup>, the goal of the Harding administration was to return prices to their pre-war levels and this had been substantially achieved by the end of 1921. Between January and July, 1922, the wholesale price index rose 12% but, thereafter, remained highly stable. After 1925, wholesale prices fell with a total decline of 8% between 1925 and 1929. During the great stock market boom of 1927-1929, prices emerged slightly lower at the peak than they had been in the period immediately prior to the expansion.<sup>2</sup>

The behavior of prices suggests the Federal Reserve had abandoned its traditional passive role and adopted a conscious policy to achieve price level stability by means of open market operations. The behavior of interest rates, discussed below, is another and corroborating indication. Such stability would not have been likely without active interference by the central bank. This role for the System could not have been predicted from decisions made in the period between 1920 and 1923. As was discussed, the official view then was that the Federal Reserve had no control over economic developments or the volume of credit. Moreover, the majority of System officials had explicitly rejected guiding open market operations by price level developments. They had argued that the System was essentially a passive institution whose function was to guard reserves and issue currency in response to the needs of trade. Further, the political climate would not appear

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<sup>1</sup> See Warren Harding's acceptance speech (Proceedings of the 17th Republican National Convention at Chicago, June 8-12, 1920, p. 262), and the 1920 Republican Platform (*National Party Platforms, 1840-1956*, compiled by Kirk H. Porter and Donald Bruce Johnson, Urbana, University of Illinois Press, 1956, p. 234).

<sup>2</sup> Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton, Princeton University Press, 1963, pp. 284, 298. Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, p. 67. *Historical Statistics of the United States, Colonial Times to 1957*, House Document No. 33, 86th Cong., 1st Sess., p. 116.

to have been favorable to the Federal Reserve intervening to affect economic trends. But, as was also earlier noted, by 1923 many ranking officials, including especially Governor Strong and Secretary Mellon, favored using open market operations to influence economic trends, though they did not all have the same goals in mind. Strong, for example, argued for using open market operations contracyclically whereas Mellon favored their use to counteract inflation but feared easy money policies to counteract depression.

The fact that the Open Market Investment Committee took credit for "shortening the duration" of the 1923-1924 recession by "contributing to easier money" produced the reaction one would have anticipated.<sup>3</sup> It was the sort of statement which bankers continued to associate with populist doctrines. Thus, the American Bankers Association issued a statement protesting the easy money policy of 1924, but basically they trusted the men who were then in control of the System. The policy had originated with one of their own kind—Benjamin Strong, the governor of the Federal Reserve Bank of New York. Also, they were reassured by the fact that Andrew Mellon—a man for whose opinion they had the greatest respect—occupied a position of influence in monetary matters as Secretary of the Treasury and hence as an ex-officio member of the Federal Reserve Board, and that Mellon favored using monetary policy to prevent inflation. Writing at the invitation of the Chamber of Commerce in a 1925 issue of *The Nation's Business*, Secretary Mellon put the case for using the Federal Reserve to prevent expansions from developing into inflations as follows:

This ability of the system to exercise a steadying influence on credit conditions is its most valuable function. The more carefully the credit facilities are handled and the more orderly the development of business expansion, the greater will be the duration of the periods of prosperity and the less severe will be subsequent reactions.

A thorough knowledge and development of credit control by those who direct the system and an understanding of the same by the business public should lead to the maintenance of business on a more even keel in the future than in the past and is the most important single factor in the future development of the Federal Reserve System.<sup>4</sup>

Viewed together with the Open Market Investment Committee's analysis of the contribution of easy money to recovery from the 1923-1924 recession, the Secretary's statement is evidence that the System had made a major conceptual advance and had developed more sophisticated tools to implement its policies. It had enlarged the limited objective of accommodating business to include responsibility for modifying the business cycle by making credit more easily available during a period of recession and less easily available during a boom. Having discovered, in the years 1922-23, the impact of open market purchases and sales on the level of member bank reserves and market rates, it could more effectively control the volume of credit than when, in 1920-21, it had relied heavily on the discount rate. The knowledge which the System gained from the disaster of 1920-21 and its aftermath was set forth at length in its Annual Report

<sup>3</sup> Report of the Open Market Investment Committee, November, 1924. Federal Reserve Board File 333.b.2.

<sup>4</sup> Andrew W. Mellon, "What Future for the Federal Reserve?", *The Nation's Business*, Vol. 13, No. 5, May 1925, pp. 26-27.

for 1923. The report contains a skillful analysis of criteria for policy but rejects the use of any single criteria—such as reserve ratios, exchange rates or price index numbers—as a guide. It argues that policy “is and must be a matter of judgment,” based on careful examination of all available evidence of changes in production, trade, employment, prices and commodity stocks.<sup>5</sup>

But the 1923 Report is somewhat misleading. An analysis of documents of the period which record the decision-making process reveal that the System did have a single objective criteria: it consistently used the level of interest rates as a guide for policy. Rate levels had been a major criteria from the beginning, but reserve ratios were considered more significant until gold inflows made them meaningless as an indicator of domestic credit conditions. The shift to rate levels was inevitable as open market operations became more important, because the impact of these operations on market rates was immediate, and because the maintenance of stable interest rates was acceptable as a goal to the broadest spectrum of political and economic factions.

Interest rate stability was, moreover, largely achieved between 1922 and 1929. The Federal Reserve may not have produced this stability but at least System actions did not themselves cause interest rates to move erratically as has been the case so many times since 1929, including recent years. Except for an 8-month period in 1924–25, the prevailing rate on prime commercial paper, 4 to 6 months, remained between 4.13 and 5.38 percent. From July, 1924 to February, 1925, the rate fell below 4 percent, to a low of 3.13 percent in September and October, 1924. Similarly, rates charged on customers' loans by banks in major cities remained above 5 percent during most of the period, dropping only slightly in response to the easy-money policies of 1924 and 1927. On the other hand, commercial rates did not rise above 6 percent until May, 1929.<sup>6</sup>

An article in the July, 1926 Federal Reserve Bulletin discussed the System's ability to produce stable market conditions and compared average fluctuations in money rates and currency in circulation for the years 1910–13 and 1922–25. During the earlier period, currency in circulation had remained relatively constant while interest rates had fluctuated over a broad range. In the later period, the situation had been reversed. As the *Bulletin* commented:

Under present conditions . . . the currency is elastic and both expands and contracts in response to seasonal demands while money rates fluctuate over a much narrower range (emphasis supplied).<sup>7</sup>

Since average annual interest rates were relatively high for the years 1910–13, the contrast offered further proof of the remarkable advances made possible by the creation of the Federal Reserve System. Rates were not as low as they had been in some other periods, however—depending on which 3-year period might be selected—nor as low as they had been between 1915 and the declaration of war in 1917. The System's goal during its first few years had also been to maintain stable interest rates, but the emphasis had been on maintaining rela-

<sup>5</sup> *Tenth Annual Report of the Federal Reserve Board (1923)*, p. 32. See also chapter V, part 5, and Appendix A.

<sup>6</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, pp. 450, 463.

<sup>7</sup> *Federal Reserve Bulletin*, July 1926, p. 471.

tively low levels. The actual range for rates on commercial paper had been between 3.45 and 4.38 percent.<sup>8</sup>

As noted above, the behavior of prices between 1923 and 1928 was similar to that of interest rates, which is not surprising since interest rates contain an inflationary component and hence are most likely to be stable when prices are. The System claimed no influence over prices, however, and there is no indication that any Reserve official, except Governor Strong of the New York Bank, saw price stability as a policy objective. Even Governor Strong rejected the use of a specific level of prices as a target, although such a concept had gained substantial support outside the System and was embodied in the so-called stabilization bills of the period. Testifying against these measures, he argued that the System could only gain in effectiveness if it were left free of legislative entanglements.<sup>9</sup>

The behavior of interest rates and prices, and the fact that the System took credit for ending the recessions of 1923–24 and 1926–27 seem to indicate a commitment to countercyclical policy. Nevertheless, only a minority of Reserve officials favored such objectives and as events after his death in 1928 indicate, Governor Strong was probably the only official who had both the influence and the knowledge necessary to conduct countercyclical operations. The extent to which a countercyclical policy had been successful in the years 1923–28 is thus perhaps more an indication of Strong's economics and dominant position than it is evidence of an advance in the overall level of understanding within the System, though definitely, as analysis of the October, 1922 Symposium shows, there was increasing recognition of Federal Reserve responsibility for economic events, particularly "the prevention of disaster," as put by Governor Norris.

The key to Strong's success was the fact that the New York Bank had control over open market operations. Also he virtually represented the United States in international financial matters and his prestige abroad tended to enhance his position at home. The implementation of Governor Strong's policies was, however, frequently impeded by pressures and demands from various factions within the System. Reserve bank governors complained that the amount of assets purchased by the System was inadequate in terms of their needs for earnings and threatened to ignore or dismantle the Open Market Investment Committee. Secretary Mellon was the Committee's protector but viewed its function with ambivalence. Like many within the System, he valued the deflationary aspects of open market operations—their usefulness in raising money rates—but feared the System's power to create more money.<sup>10</sup>

Secretary Mellon insisted on the Board's prerogatives in determining the maximum limitation of the System portfolio and saw to it that the amount was kept low. Only in the latter months of the 1924 and 1927 recessions were the System's holdings permitted to rise to \$500 million. As a result, the Committee frequently lacked sufficient assets to pursue a deflationary policy as aggressively as Mellon desired. How-

<sup>8</sup> *Banking and Monetary Statistics*, p. 450.

<sup>9</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, pp. 204, 246.

<sup>10</sup> See the letter from Under Secretary of the Treasury S. Parker Gilbert, Jr., to Deputy Governor J. H. Case of the New York Bank, August 3, 1923. FRB File 333.b.1.

ever, his conflicting goals were no more self-defeating than those of the Reserve bank governors. They frequently argued that conditions were ripe for an increase in the discount rate while insisting that they must have more earning assets to meet expenses.

While the Committee advocated easy money as a response to recession, it had as little tolerance for low rates as a normal market condition as any other faction in the System. In both 1924 and 1927, it acted prematurely to reduce its portfolio in order to "firm up" rates. As a result, both recoveries were quickly followed by slight slumps. In 1925, however, the recovery was almost as energetic as it had been in 1923. Gross national income in constant dollars increased 4½ percent in 1925 and 5½ percent in 1926, viewed on an annual basis.<sup>11</sup> The figures on unemployment are more revealing. As high as 11.9 percent in 1921 and up to 5.5 percent during the 1924 recession, unemployment dropped to 1.9 percent in 1926, the lowest level for any non-wartime period from 1907 to date.<sup>12</sup>

The post-recession period in 1928 was different. It has been suggested that the System maintained rates too high to avoid dampening the overall economy but too low to control the stock market. Actually, they were attempting to do just the reverse—keep rates low enough to stimulate the economy but high enough to check the rate at which funds flowed into the market. As a result of this policy the amount of bank credit supplied, including for speculative purposes, was restricted, thus laying the groundwork for economic weakness. But the policy did not prevent the 1928–29 stock market boom. For though bank credit flowing into equities was reduced there was an even heavier flow of funds into the stock market from non-bank sources. The market boomed even higher, while the economy slowed significantly in 1928, though there was a temporary recovery in 1929.

Numerous theses have been advanced to explain the 1929 Stock Market Crash but it has proved easier to indict the Federal Reserve System for its failure to alleviate the Depression than to guess what policies it might have pursued to prevent the financial debacle that triggered it. It would appear, however, that the ability of Reserve officials to control interest rates during the period of prosperity had given them a false sense of security. After the searching analysis of 1922—prompted, perhaps, by the painful experience which preceded it—no further effort was made to explore the relationship between money and credit and economic performance. Worse, the successful monetary remedies of the 1920's were a failure when projected into the 1930's. The maintenance of low interest rates alone was not enough to stimulate the economy in the Depression.

Given the willingness of Federal Reserve officials to intervene and shape economic events during the decade ending in 1929, their failure to respond to the disaster which followed requires some explanation. The dominant position of Governor Strong left a negative legacy for the System. The resentment of other officials erupted in 1928 in a proposal to abolish the Open Market Investment Committee and to return control of open market operations to the Governors' Conference. By 1930, however, when this proposal went into effect, the

<sup>11</sup> Wicker, *op. cit.*, p. 95.

<sup>12</sup> *Historical Statistics of the United States*, p. 73.

past proved to be irretrievable. Given the increase in the size of the Federal debt and the status of Government securities as collateral for Federal Reserve loans, open market operations now functioned as a major monetary tool rather than a subsidiary device for earning expenses and developing a market for bankers' acceptances. Its effectiveness was, however, undermined by delayed policy decisions and the dispersal of responsibility. Further, at this point, a majority of Reserve officials, including a now bemused Secretary Mellon, reverted to the old "needs of trade" doctrine which held that policy should be adapted to current cyclical conditions. *What this meant in 1930 was that the System contracted credit as business declined.* This set off a further decline in business, followed by a further contraction of credit and so on. Little or no effort was made to halt the deflationary spiral—to stimulate an expansion, as Governor Strong would perhaps have suggested, by actively buying securities in the open market.

Ironically, what did remain as Governor Strong's legacy, the creation of an independent open market committee within the System, had eroded the effectiveness of the Federal Reserve Board and erased the last vestiges of the concept of public control, the dominant principle in framing the original legislation. The notion of the Board as "a part of the Government itself"<sup>13</sup> had not been lost but the locus of control had shifted to officials more closely allied with private interests than with Government. This aspect of the shift had not been noticed during the 1920's, but with a change in the political climate in the 1930's, it added a new dimension to existing antagonisms between the Board and other groups within the System. It was not until Marriner S. Eccles was appointed as its governor that the Board reasserted its right to determine policy on the grounds that public control of the System was intended. Impelled by events, the Board proposed a more dynamic conceptual framework for policy and initiated sweeping legislative reforms to clarify its position and insure a subordinate role for other officials. Only some of these proposals were enacted.

The foregoing narrative barely scans the complex events it attempts to describe. It presumes, perhaps, that one can trace conscious elements in policy-making where responsibility and power are diffuse and theory and practice at odds. Only a closer examination of events during this period can reveal the extent to which the System groped for its proper role in forming and interacting with public policy.

<sup>13</sup> Remarks of Rep. Carter Glass on the Federal Reserve bill, September 10, 1913. *Congressional Record*, Vol. 50, p. 4644.

## CHAPTER VI

### CONFLICTING VIEWS OF MONETARY POLICY: 1923-24

#### 1. *Triumph of the Treasury's views—tight money and elimination of open market operations as a countercyclical policy tool—May 1923*

As was earlier discussed, the System had reduced its portfolio of Government securities beginning in June, 1922. From the high point of \$630 million on June 14 the portfolio fell to \$353 million on January 31, 1923. At this time, however, Reserve bank demands for earning assets to meet expenses came into conflict with the policy of liquidation and one of the Reserve banks bought \$2 million of Government securities acting on its own for its own account. As a consequence of the conflict, the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities was reorganized in April 1923 by the Federal Reserve Board, which asserted its right to pass on the volume of purchases or sales. The impetus for such a move ostensibly came from Adolph Miller of the Board but it had Treasury backing as well. The new committee—named the Open Market Investment Committee and actually composed of the same five governors as before—had met only once when, on May 31, 1923, the Board sent an order instructing its Chairman to liquidate the *entire* portfolio of Government securities.

The reaction of George W. Norris, the Governor of the Philadelphia Bank and a member of the Committee, expressed the view of a majority of the Reserve bank governors. Governor Norris challenged the Board's assumption of "power to impose upon the Directors of the several banks a policy on this subject which is at variance with their own judgment," on the grounds that "the Federal Reserve System is a Regional and not a Central banking system." He agreed to sell the Bank's allotment of securities, but gave notice that the board of directors of the Philadelphia Bank "reserves full liberty and discretion to dissent from any future recommendation which the Committee may make."<sup>1</sup>

Governor Norris' assertion of independence for his bank was triggered by his opposition to liquidations. The Reserve banks depended on the assets held in the System portfolio for supplemental earnings. The liquidations forced by the Treasury in 1922-23 had meant not only the loss of these assets but actual losses on the securities themselves. The securities had been purchased by the Reserve banks individually between November 1921 and April 1922 and then pooled into a single account. They had accepted this arrangement—with the understanding that they would still get the benefit of the earnings on a pro-rata

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<sup>1</sup> Letter from Board Governor Daniel H. Crissinger to J. H. Case, Deputy Governor of the Federal Reserve Bank of New York and Acting Chairman of the Open Market Investment Committee, May 31, 1923; FRB File 333.b. Letter from George W. Norris to J. H. Case, June 8, 1923; FRB File 333.b.

basis—because Governor Strong of the New York Bank had made a convincing case for the fact that, by making purchases individually, the Reserve banks were competing with each other and bidding up prices on securities; that uncoordinated purchases had an impact on the market which was often at variance with rate policy; and that coordinated purchases and sales could be used to supplement rate policy and make it more effective.<sup>3</sup> Having voted for the establishment of the Committee on those grounds, the Governors felt doubly betrayed when practically all their earning assets now were sold off without any seeming relation to policy objectives.<sup>3</sup>

Governor Strong, chairman of the Open Market Investment Committee, was apparently no less opposed to Secretary Mellon's insistence on liquidations but had tried to prevent a direct confrontation with Treasury officials of the sort which had occurred in 1919 because he thought the Treasury had the advantage in such a situation. As noted previously, he advised the governors during the May, 1922 Conference not to insist on their rights and to cooperate with Mellon.<sup>4</sup> However, Strong had an overriding interest in centralized open market operations, demonstrated by the fact that he had been engaged in constructing and reconstructing mechanisms for controlling these transactions since 1915. His conciliatory attitude may reflect an awareness of the value of having Treasury support for the fledgling committee at whatever cost to immediate policy objectives.

Meanwhile, the Treasury continued to argue that the Reserve banks interfered with its operations when they bought Government obligations. Because of their volume, it was said, Reserve bank purchases drove the price up in an artificial way, and when the Treasury attempted to sell a later issue, it had difficulty gauging what a normal market price for the issue might be. However, Secretary Mellon's opposition to open market operations was consistent with his view of the scope of Federal Reserve powers. He did not think the System should act to influence rates but, since he believed it was responsible for the drop in rates to May, 1922, he thought it justified in providing the antidote. A substantial part (\$277 million) of the System's portfolio had been liquidated between June, 1922 and February, 1923. Now, in May, 1923, Secretary Mellon insisted on complete liquidation, overriding a suggestion from the Committee that sales be limited to \$50 million. Despite Governor Norris' protest and an indignant letter from the Committee itself to the Board, sales were made as requested.<sup>5</sup>

<sup>3</sup> *Stenographic Record*, May, 1922 Conference of Governors, pp. 540-551.

<sup>4</sup> During the May, 1924 Conference, Deputy Governor Case observed that it was "the opinion of practically everyone of the Governors that a mistake was made in practically forcing the Federal Reserve Banks to divest themselves of this substantial portfolio of Government securities . . ." (*S.R.*, May, 1924 Conf., p. 22). Again, the views of Governor Norris are representative of those of a majority of the governors:

"The reduction of our holdings of Government obligations, which began in May of 1922, was brought about, as we all know, because of the insistent representation of the Treasury Department. Their objection to it (the increase in System holdings) was not on any broad general question of credit policy, but on the ground that our purchases produced an abnormal and artificial market for Treasury obligations. Now we are discussing whether or not it would be advisable for us to resume purchases, and before we reach any decision, before we even go any further in the discussion, I would like to know whether the attitude of the Treasury Department has changed, and they are now willing that we should make purchases, or whether, if we did make purchases, they would then renew the attack that they made on us in May, 1922, and insist upon our selling them at a lower price immediately after we had bought them at a high price?" (*S.R.*, Nov., 1923 Conf., p. 33.)

<sup>5</sup> *S.R.*, May, 1922 Conf., pp. 119-121.

<sup>6</sup> *Ibid.*, pp. 520-524.

Report of the Open Market Investment Committee, May 23, 1923. Letter from Under Secretary Gilbert to Governor Crissinger, May 30, 1923. Letter from Governor Crissinger to J. H. Case, May 31, 1923. Letter from J. H. Case to Governor Crissinger, June 11, 1923. FRB File 333.b.

On August 3, 1923, Under Secretary of the Treasury S. Parker Gilbert expressed satisfaction in a letter to the Acting Chairman of the Committee, J. H. Case :

The position has been well liquidated and is now under control. That of itself will help to make the discount rate more effective when the time comes.

Gilbert then stated the Treasury's attitude toward the Reserve banks :

I hope that it will never again be possible for any Federal Reserve Bank or Banks to run up a situation like that which developed in the first half of 1922, and that if anything of the sort ever threatens again the Committee of Governors and if necessary the Federal Reserve Board, will step in and stop it before it gets started. I am afraid that if the Federal Reserve Banks were left to themselves many of the Governors would be off again on a frolic of their own whenever their earning assets began to fall. All of them have gone along well with the Committee, but I suspect that many of them are still quite unredeemed.<sup>6</sup>

*2. Impulse for open market purchases: The need for earning assets, the 1923-24 recession*

When Governor Strong returned in the fall of 1923 and resumed the chairmanship of the Open Market Investment Committee, its future role in determining policy was not very promising. It appeared that the Committee was to act as an instrument of the Treasury, serving as a watchdog over the System's potential for creating easy money. The Treasury's bias for tight money in this instance is not the bias which is usually asserted in referring to differences between the Federal Reserve and that Department, as was earlier discussed, but the impositions of restraint were no less real than in other periods.<sup>7</sup> Without the Treasury's support, however, the Committee would have been unable to control the Reserve banks, who continued to insist on their right to purchase securities on their own initiative. On the other hand, pressure from the Reserve banks to purchase securities in view of their need for earnings worked to the advantage of the Committee in its dealings with the Treasury.

In September, 1923, the Dallas Bank requested approval to purchase \$10 million of Government securities, citing its low earning position, its lack of surplus and the large number of bank failures in the district which put a strain on its resources. The Open Market Committee agreed to make an exception in the case of the Dallas Bank, but could not grant the request without approval from the Federal Reserve Board. The Board, in turn, voted to approve the request, "subject to a conference with officials of the Treasury." The Treasury approved, but early in November when the Boston Bank made a similar request—to purchase \$20 million of Government securities "to build up the earning assets of the bank"—permission was denied. The Boston Bank made no mention of recessionary trends in its district or the relationship between a decline in business loans and the need for investments to help cover expenses, but these developments were brought up at the November, 1923 Conference of Governors. Meanwhile, the Board's position was that purchases by the Boston Bank would affect the money market and that it saw "nothing in the conditions of the money market which

<sup>6</sup> Letter from Under Secretary Gilbert to J. H. Case, August 3, 1923. FRB File 333.b.1.  
<sup>7</sup> Further examples of the Treasury's bias for tight money during this period are its pressure in August, 1923 for an increase in discount rates "in the not distant future" (S.E., Nov., 1923 Conf., p. 637), and the complaint that the Reserve banks' efforts "to establish a market for bankers' acceptances" had led them "to undersell the open market" (FRB File 333.b.2.)

would warrant the Boston bank or any other Reserve bank purchasing Treasury securities at this time.”<sup>8</sup>

The report of the chairman of the Open Market Investment Committee to the November 1923 Conference of Governors is quite different in tone:

Finally, quite another view is presented when we consider just what our policy should be in case the hesitation and uncertainty which seems to have arisen in some sections, notably New England, should threaten a real set back to business. While the country is now on the whole prosperous, labor quite fully employed, most mills are busy and with a few exceptions no excess stocks of goods on hand—there are also some indications of a growth of distrust lest business is facing a slump. Steel orders are lower, production of New England cotton mills has recently been reduced, automobile tire business has slowed down, and we have had a long and rather sharp liquidation in the stock market resulting in a reduction of Stock Exchange loans, estimated at \$532,000,000.

It is the view of the Committee that the reserve system should not hesitate to resume open market purchases, thereby again reducing bank borrowings and easing money rates, rather than permit an unwarranted state of mind alone to disturb the even course of the country's production and consumption. There need be little fear of inflation from such a policy if total earning assets are not allowed to increase; nor are they likely to do so in the absence of speculation, increasing prices and increasing stocks of goods.<sup>9</sup>

Governor Strong's comment on the off-the-record discussion which followed the reading of the report to the Conference indicates the extent of opposition to the proposal:

I am led to believe by the discussion that the feeling may have developed that this report recommends more definitely than it actually does going into the market and buying Government short term securities. It doesn't really recommend that. It suggests that the time may come when that would be a very desirable thing to do.<sup>10</sup>

Despite this qualification, it is clear that Governor Strong used the November, 1923 Conference as a forum for discussion of the nature of countercyclical open market operations. To set the stage, using National Bureau reference points, a business recession had begun in the spring of 1923 which was to last until the summer of 1924. Governor Strong pointed out that the liquidation of \$500 million of Reserve bank assets between May, 1922 and May, 1923 had resulted in an increase in member bank borrowings of the same amount. He also noted the concurrent rise in interest rates—bills had risen from 3 to 4½ percent and commercial paper from below 4½ to 5½ percent. He suggested that these events were reflected in the current situation and that one could anticipate pressure on borrowers and pressure for liquidation as banks moved to reduce their borrowings to the System.

The impact of such pressure on the general business situation was, Governor Strong said, “one of those intangible things you cannot measure . . .” He suspected, however, that “it may have a considerable effect,” in that “you cannot squeeze five hundred millions out of the stock speculations in New York without developing a feeling of pessimism . . .” Governor Strong did not of course have perfect hindsight. He was not yet prepared to view the situation as sufficiently

<sup>8</sup> Letter from B. A. McKinney, Governor, Federal Reserve Bank of Dallas, to Edmund Platt, Acting Governor of the Federal Reserve Board, September 29, 1923. Proceedings of the Board, October 3, 1923. Letter from Platt to McKinney, October 4, 1923. Letter from W. P. G. Harding, Governor, Federal Reserve Bank of Boston, to Platt, November 2. Board Communication to W. P. G. Harding, November, 1923. FRB File 333.b.1.

<sup>9</sup> Report of the Chairman of the Open Market Investment Committee to the November 1923 Conference of Governors. FRB File 333.b.2.

<sup>10</sup> S.R., November, 1923 Conference, p. 29.

grave to warrant intervention but suggested that if what today is termed a recession were to develop, the System should be prepared to increase its purchases of Government securities and thus reduce pressure by enabling the member banks to get out of debt to the System.<sup>11</sup>

Governor Harding of the Boston Bank, the former Governor of the Federal Reserve Board and one of the officials most sensitive to open market dynamics, suggested that rather than wait, the Committee might "anticipate a little bit." He suggested that rates might drop in January or February as a result of the recession, and that to buy securities at that point would make the market too easy. Strong shared Harding's concern that rates might drop too low and agreed that he "would anticipate as you indicate, Governor Harding"; since, if purchases were made in November, "we would have opportunity, in case there was a runaway market, to turn loose Government securities and take up a little of the surplus cash." However, Governor Strong added that he did "not think the Federal Reserve Board would consider that."<sup>12</sup>

These remarks give a fair indication of the various policy objectives of the period. Stable interest rates had the highest priority within the System. For Governor Strong they were a necessary means to the end of stabilizing production and prices. For most Reserve officials, however, the maintenance of a given level of interest rates in itself constituted stability. The following statement by Governor Calkins illustrates the latter view:

. . . That was argued at the time this policy was discussed before, that the operations of the Open Market Investment Committee might be so carried on as to avoid fluctuation in discount rates; in other words when the market was unduly easy we might take the money out of it, and when it was low we might put some money into it. As a matter of fact the operation of the committee has been along exactly opposite lines; it has put money into the market when it was unduly easy and it will, contrawise, be taking money out of the market when the market is beginning to tighten. I have always thought it was a mistake for the Federal Reserve System to dispose of the large investments in Government securities at the time they were disposed of and if it was a mistake to do that at that time it was also a mistake to go back into the market and buy 200 million dollars worth at a time when there was no necessity for it. The fact that it hasn't any appreciable influence upon rates is indicated by the reduction of the New York rate to four percent.<sup>13</sup>

Governor Calkins' last sentence is telling. New York had lowered its rate in May, 1924 from 4½ to 4 percent in response to conclusive evidence of a business recession. Nevertheless, most of the governors—and Governor Calkins was one of the more sophisticated—were not in the habit of reacting to production indices and unemployment figures. The market was easy and required firming action in the form of open market sales. A reduction in the discount rate would appear indefensible in terms of a concept of "countercyclical policy" which focused on rate stability.

<sup>11</sup> *Ibid.*, pp. 30–32.

In the discussion of the scissors-effect of open market operations, Governor Strong observed that when purchases were made and banks were found to have a surplus, they tended to invest it in assets that would turn over quickly; and that this had the effect "of reducing the rate on the most fluid things in the money market." The response of Governor Seay of the Richmond Bank is illustrative of the attitude which made many Reserve officials suspicious of open market operations. He questioned whether or not the System "should . . . adopt a policy which will probably result in some slight lowering of the return on these securities" (*Ibid.*, pp. 24–25).

<sup>12</sup> *Ibid.*, pp. 34–35.

<sup>13</sup> *S.R.*, May, 1924 Conf., p. 19.

Governor Strong did not, of course, wholly agree with this position but conceded that Governor Calkins had a point:

... This Committee had wished upon it a job of going out and making investments at a time when the market situation was not favorable. They have done the best they could. The Committee was very strong in its contention that a mistake was made in reducing the holdings in Government securities from upwards of 600 millions down to practically nothing, and was also strongly of the opinion that if we had been permitted to have retained perhaps 300 million of those at that time, that on March 1st, when the market was shot to pieces and call money went down to two and a half percent, that this committee would have been functioning and functioning beautifully along the lines that were intended...<sup>14</sup>

This statement and the discussion with Governor Harding during the November, 1923 Conference reveal that Strong's concept of counter-cyclical operations did not exclude all aspects of the more traditional approach. Although the overall objectives of policy might call for an enlarged volume of purchases, he would not hesitate to switch to sales to firm-up market conditions, utilizing the Committee in a way similar to the way in which bankers' pools organized by J. P. Morgan and others had functioned in an earlier period. However, the Committee had been unable to correct the disorderly conditions which had developed in the market because it had only \$50 million in assets at the time. It had to build up the portfolio at a time when market rates were easing—a situation it would have wished to avoid—but which, in principle, had the effect of diminishing the amplitude of the recession which the National Bureau dates as having begun in May, 1923.

While Reserve officials more or less accepted the Committee's recommendations, few accepted or fully understood the means for obtaining them. A resume of the Committee's activities at this time illustrates the extent to which policy was shaped by other factors: the struggle for control by various groups within the System, the need for earnings and, again, misconceptions as to the timing of purchases and sales to achieve the desired objective.

Following the November, 1923 Conference, the Open Market Investment Committee made a tentative recommendation which reflected Strong's feeling that the Board would not approve a large volume of purchases. It voted to buy "a suitable volume of Government securities of short time maturities, provided such purchases can be made without disturbing the conditions of the money market or of the market for Government securities." On December 3, the Board replied, approving a "limited volume" of purchases, but emphasized its prerogative to control the volume:

... it being understood that the Board reserves the right to discontinue purchases and to require the sale of any of the securities purchased in pursuance of this resolution at any time it may deem expedient.<sup>15</sup>

At the beginning of January, 1924, the Committee recommended purchases of \$15 million. On January 12, Randolph Burgess, then an official of the New York Bank, sent a memorandum to Deputy Governor Case warning that if the current policy "toward reduction of the earning assets of the System" were continued, the earning po-

<sup>14</sup> *Ibid.*, pp. 20-21.

<sup>15</sup> Federal Reserve Board resolution, December 3, 1923, FRB File 333.b.1.

sition of the Reserve banks would become serious unless business picked up. The Committee prepared a statement indicating that, as of January 30, the System's earnings were at the lowest point since November, 1917. Anticipating pressure from the Reserve banks for individual purchases, the committee revised its allotment plan to make the need for earnings, rather than the reserve positions of the various banks, the basis for distributing assets. It urged that individual purchases be curtailed and Governor Strong again appealed to the Federal Reserve Board to support its position. Strong's letter notes that Dallas had again requested a special order and that he had sent them \$5 million of bankers' acceptances out of the New York Bank's portfolio in an effort to solve the problem without special purchases, resumption of which, he argued, would be a disaster.<sup>16</sup>

On February 21, the Board voted to support the Committee's position.<sup>17</sup> The effect was to delay the commencement of substantial purchases by the System for several months. Thus, the "natural" countercyclical tendencies of the System were thwarted in the process of centralizing open market operations. If the Reserve banks had not been prevented from making individual purchases, the System would have moved to alleviate the recession much earlier. Since, at this time, recessionary tendencies had a direct effect on Reserve bank earnings, some banks would have made purchases as early as September, others in November and the remainder by January. As it was, the System did not make substantial purchases until April, the reason being that the Committee wished to avoid any further easing of rates in a market which was already declining.

In January, Burgess had stated the problem for the Committee: business was "continuing to recede in volume rather than increase," but as indicated by the level of interest rates, "the situation clearly contains a threat of serious inflation." Therefore, he concluded, "the time has not yet come to sell securities . . . we should rather continue to acquire more as far as we can do so without making easier a market already very easy." The problem of rate levels was noted again in February in a memorandum drafted for Strong by Case and Burgess. Assessing the current situation, they wrote: "There does not appear to have been any marked change in the volume of production or distribution of goods, which are maintained at approximately the same level as in the late months of 1923 and considerably under the spring months of that year." Nevertheless, they argued that "the authorized buying rate should not be lowered at this time." This recommendation was adopted at the February, 1924 meeting of the Committee, together with a recommendation for "increased purchases in moderate volume." Even in April, when it had decided to make a large volume of purchases, the Committee restricted itself to purchases "at current market prices." It was hoped that this form of support could prevent any sudden drop in market rates since there were many officials within the System who, like the members of the Federal Advisory Council, agreed

<sup>16</sup> Memorandum from Randolph Burgess to J. H. Case, January 12, 1924. Report of the Open Market Committee, February 8, 1924. FRB File 333.b.2. Letter from Governor Strong to Governor Crissinger, February 18, 1924. FRB File 333.b.1.

<sup>17</sup> Recommendation of the Committee on Discount and Open Market Policy of the Federal Reserve Board, February 20, 1924. Letter from Governor Crissinger to Governor Strong, February 21, 1924. FRB File 333.b.1.

to an enlargement of the portfolio of Government securities only "if this can be done without unduly affecting the market."<sup>18</sup>

The April 1924 report of the Committee noted that interest rates had declined—commercial paper was down from  $4\frac{3}{4}$  to  $4\frac{1}{2}$  percent and bill rates from  $4\frac{1}{8}$  to 4 percent—but argued that even easier rates could be justified in the current situation. The Committee stressed the fact that "practically all of the available indexes for March indicated a considerable decrease in the volume of production and business transactions," and recommended purchases of up to \$250 million. The Committee could assume that the governors would be disposed to favor the amount of purchases suggested, but not necessarily on the grounds that interest rates should be lowered and member bank reserves raised to counter a business recession. It strengthened its argument by noting, at the May, 1924 Conference of Governors, that the System was still short \$18 million of earning assets to cover estimated expenses for 1924 even after the substantial purchases in April which had been approved by the Board. The Conference voted to increase the System account by purchases of an additional \$150 million of Government securities, and adopted a new plan of allotment based on earning requirements.<sup>19</sup> With the backing of the Conference, the Committee obtained prompt approval from the Board. This did not solve the problem of earnings, however, and in June both the Chicago and Philadelphia Banks threatened to make substantial individual purchases to meet expenses.<sup>20</sup> Therefore, the Committee voted on July 1, 1924, to increase System holdings by another \$100 million and to make purchases "in so far as possible . . . in other districts than New York." In that way it was hoped that the Committee could absorb what was available in local markets and make individual purchases more difficult.<sup>21</sup>

While the Committee had found it necessary to frame its policy in terms of the needs of the various factions, it had nevertheless been able to meet its objective of implementing successful countercyclical operations. Between the end of April and the beginning of September, 1924, the Committee bought \$500 million of Government securities, wiped out member bank indebtedness and the recession now ended. Its July report had stated that it would favor increasing still further the \$500 million limitation "if conditions remain substantially as they are now,"<sup>22</sup> but this had not proved necessary. The New York Bank had lowered its discount rate in May from  $4\frac{1}{2}$  to 4 percent, and lowered it again in June to  $3\frac{1}{2}$  percent and in August to 3 percent, forcing a reduction in rates at the other Reserve banks as well. In public pronouncements, the New York Bank stated that its rate had followed the market down. Within the System, however, it had had

<sup>18</sup> Memorandum from Randolph Burgess to J. H. Case, January, 1924. Memorandum from Burgess and Case to Governor Strong, February, 1924. Minutes of the Open Market Investment Committee, February, 1924. Report of the Open Market Investment Committee, April, 1924. FRB File 333.b.2, May 1924 Recommendations of the Federal Advisory Council, FRB File 333.b.1.

<sup>19</sup> April 1924 Report of the Open Market Committee on "Credit Conditions and the Open Market Program." April 22, 1924 Report of the Secretary to the Open Market Investment Committee, May, 1924 Report of the Open Market Investment Committee, FRB File 333.b.2.

<sup>20</sup> Federal Reserve Board Communication to the Open Market Investment Committee, June 4, 1924. Letter from Governor Strong to Governor Crissinger, June 30, 1924. Letter from Governor Norris to Governor Crissinger, June 18, 1924. FRB File 333.b.1.

<sup>21</sup> Minutes of the Open Market Investment Committee, July 1, 1924. FRB File 333.b.2.

<sup>22</sup> *Ibid.* FRB File 333.b.2.

to defend its reductions and had argued that they were a justifiable response to the business recession. It was the first time that the System had deliberately acted to lower interest rates and there were misgivings even among those who had supported such policies, as Governor Calkins' remarks at the May, 1924 Conference suggest. Deputy Governor Case had defended the New York position by pointing out that, as Governor Strong had predicted, the \$250 million of assets purchased in late April and early May had not increased Reserve bank earnings. Reserve bank earnings had continued to decline because business continued to recede. The Committee's purchases had been made in terms of its policy objectives, not the need for earnings, and the reduction in the discount rate was justified in terms of the same policy objectives.<sup>23</sup>

In its report to the November 1924 Conference, the Committee took a less defensive tone:

... It is generally agreed by economists that the swings of the business cycle may be lessened by making credit readily available when business has begun its downward swing or is in a state of depression and conversely by making credit less easily available when business is booming and speculation is becoming rife. The program of the Open Market Committee in contributing toward easier money during the past nine months is directly in keeping with this economic principle. We have had in these nine months, and particularly in the summer of 1924, a considerable business recession. The decline in factory employment for example, amounted to more than 15%, production in basic industries declined 26% and our index of the volume of trade 15% from the high points of the spring of 1923. A genuine recovery appears, however, to have begun and the bottom of the depression appears to have been passed without serious unemployment, business failures or the like. It is entirely logical to believe that easy money has been a factor in shortening the duration of depression and loan liquidation and lightening its effects. Further, the easy money has made possible a large amount of domestic financing of which business was much in need.<sup>24</sup>

### *3. Centralizing open market operations versus independent transactions*

In assessing this report, one must note again that pressure for earning assets had been a great help in overcoming objections to an easy money policy. The problem of Reserve bank earnings had not been solved, however, and could not be solved as long as gold inflows continued. It had been the policy of the System since 1921 to sterilize gold imports by selling securities from the System account in an amount equal to the gold received. While this enabled the System to control excess reserves, it had the unfortunate effect of reducing Reserve bank income. Ordinarily, sales from the account lowered member bank reserves and precipitated an increase in discounts which compensated the Reserve banks for the loss of income from assets. Sales made to balance receipts of gold had no such effect, the point being to prevent a change in the reserve ratio.

Not all Reserve officials seemed aware of these relationships, but Governor Calkins had warned in May, 1924, that "so long as the operations of this committee are tied up with the question of earnings by the banks that the operations of the committee will be hampered, and, to a considerable extent, will be ineffective."<sup>25</sup> While this was not true during the first nine months of 1924—the pressure for earnings pre-

<sup>23</sup> S.R., May, 1924 Conf., pp. 7-8, 23.

<sup>24</sup> Report of the Open Market Investment Committee, November, 1924. FRB File 333.b.2.

<sup>25</sup> S.R., May, 1924 Conf., p. 14.

senting problems in terms of procedure rather than policy—it proved an accurate appraisal of the difficulties the Committee faced when it shifted to a more restrictive policy at the end of the year.

Pressure for rate increases came as early as September, 1924, when the Federal Advisory Council, reflecting the American Bankers Association's opposition to the Committee's easy money policies, advised the Board that a continuation of ease "might render it extremely difficult to ward off a period of active inflation." Nevertheless, with the Presidential election pending in November, the System was not disposed to make a precipitous change in policy. In October, the Open Market Committee recommended to the Board that it be authorized to *buy or sell* \$100 million of securities as conditions warranted, and turned down a request from Dallas for a special allotment. The Board approved the recommendations on November 12.<sup>26</sup>

The discretion implied in the authorization indicates that the Committee's status was considerably more secure. Nevertheless, the November, 1924 Conference was a difficult one for Governor Strong. On the one hand, he had to resist pressure for an increase in the discount rate which he felt would be undesirable in terms of both domestic and international conditions. On the other hand, he had to persuade the Reserve banks to go along with the Committee's policy of gradually reducing its portfolio even though it would mean a loss of income. The problem of earnings was again the more significant issue, and once again the attitude of the Reserve banks toward independent purchases threatened to undermine the functions of the Committee.

The governors' position on independent purchases versus centralized operations had been expressed in the Summary of the May, 1924 Conference:

It was the consensus of opinion that the open market operations of the System should be conducted independently of the question of earnings. It was also felt that while there is no question of the right of the directors of the individual Federal Reserve Banks to engage in open market operations if in their judgment that should become necessary, nevertheless the present policy of conducting the System's open market operations through the central committee appointed for that purpose, with the consent of the directors of the several Reserve banks, is highly desirable and to be commended.<sup>27</sup>

The governor's resistance to the Committee is implicit in their reference to their own rights and prerogatives. They not only insisted that their position be recognized in the policy statement, but had obtained certain concessions in terms of procedure. A majority of the governors had favored a proposal which permitted the individual Reserve banks to decline participation in System transactions. Since the emphasis was on controlling the volume of investments in terms of the maximum limitation, the Committee was not adverse to granting this form of dispensation. In fact, Governor Strong subsequently drafted a proposal which would prohibit banks capable of earning expenses from participating in new purchases. This tradition was to plague supporters of centralized open market operations in the 1930's, when policies called for massive open market purchases. Meanwhile, Governor Norris of the Philadelphia Bank obtained a concession hav-

<sup>26</sup> September, 1924 Recommendations of the Federal Advisory Council. Report of the Open Market Investment Committee, October 24, 1924. Federal Reserve Board Communication to the Open Market Investment Committee, November 12, 1924. FRB File 333.b.2.

<sup>27</sup> *Summary*, May, 1924 Conf., pp. 1-2.

ing the opposite intent. The Conference agreed that all transactions should go through the Committee except "odd lot transactions, accommodation to some local person, or transactions with member banks."<sup>28</sup> This gave the Reserve banks a loophole justifying individual purchases in small amounts and was to make it increasingly difficult for the Committee to control the total level of holdings.

Governor McDougal of Chicago had gone on record as openly approving purchases by individual Reserve banks for their own account, preferably in long-term Government securities "in sufficient amount to enable the banks to meet expenses." At the November 1924 Conference, he and several other governors had forced a vote on a proposal to permit the Federal Reserve banks to invest in long-term Government bonds in an amount equal to their capital and surplus. The motion was defeated, but the vote was 6 to 6—New York, Richmond, Dallas, St. Louis, Cleveland and San Francisco voting against the proposal.<sup>29</sup> The fact that the governors of the Boston, Philadelphia and Chicago Banks—three of the five members of the Open Market Investment Committee—voted for the proposal indicates the extent to which the Committee itself was divided. The fact that its reports reflect a countercyclical concept of policy means that the New York Bank, which handled transactions for the System account, dominated the Committee. The evident dissatisfaction of a majority of its membership would seem to support such a view.

Despite the fact that at least half of the Reserve banks wanted to increase the total level of System holdings by a large volume of individual purchases—a move which would have had the effect of lowering current market rates—almost all of the governors reported to the November, 1924 Conference that their boards of directors thought the time had come to consider rate increases. Governor Strong's frustration may have been considerable.

While actual discussion of the issue was off the record, Strong's statement of consensus indicates that he had made a forceful argument for the Committee's function, adding that the Committee was currently revising its buying rates for bankers' acceptances upward and that it had been "consistently understood in recent years (that) operations of the Open Market Investment Committee in Government securities . . . was preliminary to final consideration of changes in discount rates." It was decided that discount rates need not be increased at that point but would be increased in the near future as soon as the increase in buying rates had made conditions right for sales from the System account.<sup>30</sup> As Strong undoubtedly pointed out to the governors once again, the discount rate would then appear to be following the market, rather than leading it up.

The Governors' Conference gave the Open Market Investment Committee authority to liquidate at its discretion and by mid-December System holdings of Government securities had declined to \$413 million. Meanwhile, in November, the Reserve banks again began to make individual purchases. These autonomous holdings had only risen from

<sup>28</sup> *Summary*, November, 1923 Conf., p. 3. Memorandum from Governor Strong to the Federal Reserve Board, June 6, 1924. FRB File 333.b.1. *S.R.*, November, 1923, Conf., p. 28.

<sup>29</sup> *Minutes of the Open Market Investment Committee*, May, 1924. FRB File 333.b.2. *Summary*, November, 1924 Conf., p. 13.

<sup>30</sup> *S.R.*, November, 1924 Conf., pp. 466-469.

\$73 million to \$81 million between January and October while the System account had risen from \$50 million to \$500 million. Between November and December, 1924, however, the holdings of the individual Reserve banks rose to \$140 million.<sup>31</sup> These purchases would have been sufficient to hamper, if not offset, the effects of the Committee's sales had there not been an outflow of gold at the same time.<sup>32</sup>

The gold movements were a concomitant result of an easy-money policy and may have been anticipated by Governor Strong, but the Committee was in a position, then, of compensating not only for economic fluctuations of every sort, but for the vagaries of individual Reserve bank policies. It had to create conditions which would justify an increase in the New York discount rate early in the year—an increase, from 3 to 3½ percent, which Governor Strong had in effect promised the November, 1924 Conference. This increase brought the New York rate in line with that of the other Reserve banks and helped forestall further rate increases.

In its reports during the year 1925, the Committee began to take cognizance of individual purchases in determining the overall level of System holdings. Initially they were called "open purchases." Subsequently, in 1926, they were referred to as "other" holdings and by 1928, when they had grown to be larger than the holdings administered by the Committee, they were called "outright holdings." They not only remained a problem for the Committee, but represented the ever growing dissatisfaction of Reserve bank officials which culminated in the dissolution of the Committee in 1930 and its reconstitution with all 12 Reserve bank governors as members.

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<sup>31</sup> Report of the Open Market Investment Committee, October, 1924, FRB File 333.b.2. Report of the Open Market Investment Committee, December, 1924, FRB File 333.b.1.

<sup>32</sup> Winfield W. Riefler, *Money Rates and Money Markets in the United States*, New York, Harper and Brothers, 1930, p. 198.

## CHAPTER VII

STABILITY: 1925-26

Governor Strong had succeeded in blocking a proposed increase in Reserve bank discount rates in the winter of 1924 with the promise that the Open Market Investment Committee would act to firm up the money market and make conditions ripe for an increase in the New York Bank's rate which was then out of line with other discount rates. The advance in the New York discount rate from 3 to 3½ percent in February, 1925, brought it more nearly in line with the other Reserve banks, four of which had a 3½ percent rate and the remainder 4 percent. These patterns were maintained until November, 1925 when the 4 banks at 3½ raised their rates to 4 percent. The New York rate was increased to 4 percent in January, 1926. During the year 1926, the discount rate remained at 4 percent at all the Reserve banks except New York, which lowered its rate to 3½ percent in April but raised it back to 4 percent in August.<sup>1</sup> Throughout this two year period, open market operations were used to achieve the objective on which most of the governors had agreed—"to avoid fluctuation in discount rates."<sup>2</sup>

Measured in financial terms, this was a highly stable period with rates maintained at relatively high levels. The yield on Government bonds averaged 3.86 percent in 1925 and declined to an average 3.59 in 1926. The yield on triple A corporate bonds averaged 4.87 percent for 1925 and underwent a similar decline in 1926. Reflecting Federal Reserve support, open market rates on prime bankers' acceptance in New York City remained highly stable in terms of weekly averages in a range between 3 and 3.5 percent until the latter part of 1926. Rates on prime commercial paper were also stable during the same period, in a range between 3.50 and 4.38 percent, while the more volatile rates on new Stock Exchange call loans ranged between 2.83 percent on January 24, 1925 and 6 percent on January 7, 1926. The advantages of stable rates for financial institutions is reflected in the rise in member bank profits during this period. The ratio of net profits to total capital accounts averaged 9 percent for both 1925 and 1926.<sup>3</sup>

The particular emphasis of this period, preventing fluctuations in the discount rate, while not necessarily compatible with either the needs of trade doctrine or countercyclical concepts, was nevertheless acceptable to all factions within the System. Moreover, it was seen by the New York Bank as necessary for the maintenance of international stability at a critical time. England announced resumption of gold payments on April 28, 1925—the first step toward reinstatement of the gold standard in Europe—and both Benjamin Strong and Montagu

<sup>1</sup> *Banking and Monetary Statistics*, Washington D.C., U.S. Board of Governors of the Federal Reserve System, 1943, p. 440.

<sup>2</sup> *S.E.*, May, 1924 Conf., p. 19.

<sup>3</sup> *Banking and Monetary Statistics*, pp. 264-265, 454-455, 463, 469.

Norman, the Governor of the Bank of England, agreed that it was necessary to maintain rates in New York below those in London to protect England's gold reserve. The policy was a great success initially, and for a few years England, like the United States before, was the recipient of gold inflows. The policy, however, played havoc with the Bank of England's domestic credit policies.<sup>4</sup>

### 1. 1925

At the beginning of 1925, prior to the action by the Bank of England, the Committee sold securities to firm up rates. The System account dropped from \$413 million in December 1924 to below \$250 million by April 1925. During March, the Dallas Bank again requested permission to purchase \$10 million of Government securities because it feared that an increasing number of bank failures in its district might seriously encroach on its surplus. The Dallas Bank's chronic problem in meeting expenses reflects the fact that the Committee's sensitivity to regional economic problems was minimal. The Board ordered Dallas to stop purchasing securities and while the Bank's Governor agreed, he protested that other Reserve banks were buying and selling independently without bothering to inform the Board or the Committee. His point was well taken in that the average holdings of the Reserve banks which made purchases for their own accounts totaled over \$100 million in both 1925 and 1926.<sup>5</sup>

In April, 1925, the Open Market Investment Committee voted to enlarge its holdings up to \$300 million in "the belief . . . that present and prospective gold movements make this increase advisable." While England's return to the gold standard obviously influenced this decision, there may have been other reasons which were at least supportive. Again several of the Reserve banks were having trouble meeting expenses and the Committee met with resistance when it tried to convince those banks which were in a more comfortable position to give up some of their assets. It was easier to distribute new assets to accommodate current needs than to shift assets already apportioned to the banks.

Meanwhile, the combination of gold outflows and a reduction in the System portfolio had had a noticeably tightening effect. The Committee reported in April that "business was experiencing some slight recess . . ." There appeared to be some slight increase in recessionary tendencies in June and the Committee recommended "that money should continue to be available at moderate rates." No further purchases were recommended, however, and the Committee subsequently noted that the situation had been stabilized.<sup>6</sup> Apparently it had; the National Bureau does not record a recession for 1925. The trough of the 1923-24 cycle is dated July, 1924 and the next peak is not reached until September, 1926.

During the fall of 1925, the Committee shifted policy again as the first surge of the stock market boom became apparent. It reported to the November 1925 Conference of Governors that there had been a "gradual reduction in the portfolio . . . in keeping with the policy of maintaining the effectiveness of the discount rates . . ." There was

<sup>4</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, pp. 303, 319, 322-324.

<sup>5</sup> *Banking and Monetary Statistics*, p. 344.

<sup>6</sup> Minutes of the Open Market Investment Committee, April, 1925, FRB File 333.b.2. Report of the OMIC, November, 1925. FRB File 333.b.1. Report of the OMIC, June, 1925. FRB File 333.b.2.

considerable pressure for rate increases—the Boston Bank applied for an increase from 3½ to 4 percent in October—but action was postponed until November due to disagreements and uncertainties within the System. In view of the English situation, Governor Strong favored an increase only as a last resort. He suggested a compromise to the November Conference whereby rates would be increased gradually and only as needed.

It was decided to stagger the increases at those banks whose rate was below 4 percent and to delay an increase in the rate at the New York Bank until January, 1926. This, it was argued, would have a cumulative psychological effect which a single, across-the-board increase would not. In conjunction with the New York rate increase in January, Governor Strong suggested a moderate amount of open market sales on the grounds that “money conditions are easing considerably.” In view of the continued exportation of gold, sales of \$50 million were suggested and formally approved by the Board.<sup>7</sup>

This deflationary action was not without repercussions for future open market policy. Although the Boston Bank had led the way in pressing for a rate increase, it was the first of the Reserve banks to feel the effects of deflation on earnings and to object to the Committee’s action to back up the rate increase with sales. In January, 1926, Governor Harding wrote the acting chairman of the Committee, J. H. Case, that Boston needed \$75 million in assets to earn expenses and would not distribute its portfolio around the System until it had purchased enough for its own needs. Boston was within its rights, he wrote, because all the Reserve banks except New York followed this practice.<sup>8</sup>

## 2. 1926

Despite individual Reserve Bank purchases, the Committee’s sales, coupled with gold outflows and the rate increase, had exerted “a considerably stabilizing influence on the market,” as the Open Market Committee’s March, 1926 Report noted. Nevertheless, the Committee advised that:

... we should prepare ourselves now for the prompt purchase of some further amount of securities if and when there should be further evidence of a recession in business activity, especially if there is no further liquidation in the amount of Federal Reserve credit employed.<sup>9</sup>

Actually, the Committee had already decided on the policy which its report merely suggests. As E. A. Goldenweiser reported to Governor Crissinger, the Committee had discussed the slowdown in business activity and had concluded “that it would be desirable to bring about somewhat greater ease in the money market in order to encourage business.”<sup>10</sup>

The year 1926 proved to be an exceptionally good year in terms of growth and employment until the fourth quarter. In December 1925 the index of industrial production had fallen 5 percent.<sup>11</sup> The tight

<sup>7</sup> Report of the Open Market Investment Committee, November, 1925. FRB File 333.b.1. Letter from Deputy Governor Case to Governor Crissinger, January, 1926. FRB File 333.b.1.

<sup>8</sup> Letter from Governor W. P. G. Harding to Deputy Governor Case, January 27, 1926. FRB File 333.b.2.

<sup>9</sup> Report of the Open Market Investment Committee, March, 1926. FRB File 333.b.2.

<sup>10</sup> Memorandum from E. A. Goldenweiser to Governor Crissinger, March 23, 1926. FRB File 333.b.2.

<sup>11</sup> Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917–33*, New York, Random House, 1966, p. 100.

money policies inaugurated in November, 1925 to dampen the stock market boom had the effect of helping to perpetuate the slump. But, with the stock market under control by March, 1926, the Committee felt free to undertake countercyclical operations which were more anticipatory than its previous efforts. The Committee's success in winning approval for the kind of response which it felt would be appropriate is reflected in the fact that the New York Bank dropped its discount rate to 3½ percent in April and held it there into August. Business quickly improved, in part at least, it may be reasonably urged, because of the System's easier policies.

The August report of the chairman to the Open Market Investment Committee stated, however, that:

The reporting member banks are extending about one billion dollars more credit than a year ago, an increase which is not far from the usual increase of credit from year to year due to the country's growth. The present volume of business is not requiring any exceptional growth in credit. About half of the increase since a year ago has been in bank investments and loans on securities.<sup>12</sup>

Gross national income in constant dollars increased 4½ percent in 1925 and 5½ percent in 1926.<sup>13</sup> This rate of increase on an annual basis had apparently stimulated a new awareness of the need for an expansion of credit commensurate with the normal rate of economic growth. However, this rather sophisticated view originated with the New York Bank and appears to have made no impact on the rest of the System. The report indicates, moreover, that like the majority of Reserve officials, the officers of the New York Bank feared that easy money *per se* might further stimulate the New York stock market.

The September, 1926 report to the Committee states that it had been considered expedient to sell securities. The special investment account was reduced from \$270 to \$210 million and the report notes that these sales were associated with "a considerable increase in money rates."<sup>14</sup> A further effect of this tightening action—which included raising the New York discount rate back to 4 percent—was to precipitate a recession beginning in October. The gross national product was to drop from \$97.7 billion in 1926 to \$96.3 billion in 1927. Unemployment, which had dropped from 5.5 percent in 1924 to 4.0 percent in 1925 and to a staggeringly low 1.9 percent in 1926, rose again to 4.1 percent in 1927.<sup>15</sup>

The countercyclical operations of the Open Market Committee during 1925 and until the fourth quarter of 1926 were successful measured in terms of economic growth and employment as well as financial stability. The Committee seemed almost unaware, however, of how successful its policies had been. The failure to mention employment levels, and the rather erratic pattern of these levels over the several years cited, indicates that full employment was not a prime target but rather a fortuitous by-product of policies which had as their primary goal financial stability rather than economic performance.

A recapitulation of the shifts in policy may be helpful in revealing the pattern and its implications in terms of objectives. The easy money policy which had been put into effect in May, 1924 to counter the

<sup>12</sup> Report of the Open Market Investment Committee, August, 1926. FRB File 333.b.2.

<sup>13</sup> Wicker, *op. cit.*, p. 95.

<sup>14</sup> Report of the Open Market Investment Committee, September, 1926. FRB File 333.b.2.

<sup>15</sup> *Historical Statistics of the United States, Colonial Times to 1957*, House Document No. 33, 86th Cong., 1st Sess., pp. 139, 73.

cyclical downturn of May, 1923–July, 1924 had been followed by a policy of restraint in the fall and winter of 1924–25 to firm up interest rates and bring New York's discount rate in line with other discount rates. In April, 1925, there was a shift to an easy money policy in tandem with a slight decline in business, followed by restraint in the fall and winter of 1925–26. Again, the spring of 1926 found the System easing its policy just after an incipient downturn in business, and again, in September, it opted for restraint. While the shifts to ease were said to be a response to business conditions, and definitely were timed in tandem with incipient downturns, the shifts to restraint appear unrelated to business developments. Financial developments, rather, are the keystone to these shifts. The shift to restraint in the fall of 1924 was made to firm up the money market and level discount rates. In the fall of 1925 the shift to restraint was made to moderate an incipient stock market boom and in September 1926 the System shifted to a policy of restraint to keep interest rates stable, i.e., here to prevent them from falling. Moreover, the shift to ease in April, 1925 was motivated in part by the desire to lower U.S. interest rates to assure a capital flow from the U.S. to England. The way in which the System responded to the recession beginning in October, 1926, as discussed next, tends also to support the hypothesis that financial stability was the top priority goal of the Federal Reserve in this period.

## CHAPTER VIII

THE RECESSION OF OCTOBER, 1926—NOVEMBER, 1927

During the last quarter of 1926, in tandem with open market sales and "a considerable increase in money rates" as earlier noted, industrial production declined 6 percent and factory employment about 2 percent. The Federal Reserve System made no response to these events, maintaining the discount rate at 4 percent and confining its operations in the open market to the replacement of maturing securities. The rate on prime commercial paper rose from 4 percent at the end of July to 4.63 in September, maintained this level throughout October, and then dropped to 4.50 for the remainder of the year.<sup>1</sup> In January, there was a net addition to reserves as gold began to flow into New York in response to the higher rates. The Open Market Investment Committee, having adopted a policy of passive ease, made no effort to offset the gold imported with sales of securities. However, because of a reduction in member bank indebtedness of \$275 million there was virtually no change in the volume of high-powered money. Meanwhile, the Federal Reserve Board's index of industrial production recovered some of the loss sustained in the latter part of 1926 and it appeared that business conditions had been stabilized.<sup>2</sup>

Nevertheless, there was a 3 percent dip in wholesale prices between January and April, 1927, and a further increase in unemployment. In February, the business directors of the New York Bank pressed for a reduction in the discount rate.<sup>3</sup> By that time the rate on prime commercial paper had dropped back to 4 percent.<sup>4</sup> But the weight of opinion was on the side of tightening, not easing policy. The views of the majority were expressed by the Federal Advisory Council, which did "not believe that there is anything in the present business situation which would warrant any reduction of existing discount rates, or necessitating any change in present open market policy." The Council felt, rather, "that should interest rates continue to decline the Federal Reserve banks should reduce their holdings of bills bought in the open market." Deputy Governor Case of the New York Bank agreed with the recommendation. On March 5, he wrote the acting governor of the Board, Edmund Platt, that:

This process will, we believe, tend to absorb any substantial amount of money in the market available under 4 percent and keep our discount rate effective.<sup>5</sup>

Between March 9 and May 9, 1927, the System account was reduced by approximately \$100 million to \$136,312,000. At the May 9 meeting of the Open Market Committee, Governor Strong warned that sales

<sup>1</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, p. 455.

<sup>2</sup> Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-33*, New York, Random House, 1966, p. 107.

<sup>3</sup> *Ibid.*, pp. 107-108.

<sup>4</sup> *Banking and Monetary Statistics*, p. 455.

<sup>5</sup> Recommendations of the Federal Advisory Council, February 18, 1927. Letter from J. H. Case to Edmund Platt, March 5, 1927. FRB File 833.b.1.

would have to be discontinued as present holdings were "too small to afford security against possible future developments." Purchases in May and early June brought the portfolio back up to \$316,050,000, but were followed by sales of approximately \$60 million later in June.<sup>6</sup> The prime rate on commercial paper, which had remained at 4.13 from mid-March to June, rose to 4.25 percent. On June 20, 1927, Governor Strong outlined his views to the Board against a background of rising rates and some pressure for further tightening. Governor Strong was against further tightening but not yet for easing policy. He concluded:

So, summarizing the position as it appears to be today, I should say that we are quite willing to watch the effect of somewhat higher rates for a short period, but we believe it would be hazardous at this time to allow a general revision of the level of interest rates to occur for the reasons—

- (1) That it might force an increase in our bill rate and ultimately our discount rate,
- (2) That such an increase would be detrimental to the business of the country,
- (3) That it would have a tendency to depress the value of sterling and ultimately the continental exchanges, and possibly embarrass us by starting another gold import movement, and
- (4) That with the heavy refunding operations now under way and in prospect for the Treasury we believe that any general advance in the level of interest rates, unless necessitated by other impelling reasons, might have a detrimental effect upon the Treasury's plans which would be quite unnecessary.<sup>7</sup>

The investment account remained inactive from June 22 to July 13 with holdings of \$250,498,000. At the July meeting of the Open Market Investment Committee it was noted that "some slackening in business had apparently caused the continued fall in commodity prices," and the Federal Reserve Board accepted the Committee recommendation, authorizing purchases "not to exceed an additional \$50,000,000 of investments."<sup>8</sup> There appeared to be a change in sentiment. In the following month, August, eight of the 12 Reserve banks lowered their discount rates from 4 to 3½ percent and additional purchases—which brought the account up to \$353,467,000 by August 31<sup>9</sup>—were authorized to make the new discount rates effective. Three other Reserve banks lowered their rates at the beginning of September but one, the Chicago Bank, refused to go along. In an unprecedented and highly controversial action, the Federal Reserve Board voted 4 to 3 to force the reduction by Chicago on September 6. One of the Board members who opposed the move, C. S. Hamlin, commented that he "somewhat doubted its power to put in a uniform rate in order to help New York help the English situation."<sup>10</sup>

As Hamlin's remark indicates, it is difficult to pin-point the motivation for the easy-money policy of the summer of 1927. Two historians of the period, Lester V. Chandler and Elmus R. Wicker, note that Governor Strong initiated the policy after a visit from Montagu Norman, the Governor of the Bank of England, Hjalmar Schacht, President of the German Reichsbank, and Charles Rist, Deputy Governor of the Bank of France, in early July. They had urged that rates

<sup>6</sup> Wicker, *op. cit.*, p. 108.

<sup>7</sup> Letter from Governor Strong to Governor Crissinger, June 20, 1927. FRB File 333.b.1.

<sup>8</sup> Minutes of the Open Market Investment Committee, July 1927. FRB File 333.b.2.

<sup>9</sup> *Fifteenth Annual Report of the Federal Reserve Board* (1928), p. 74.

<sup>10</sup> Wicker, *op. cit.*, p. 113.

be lowered in New York as a means of stabilizing the European monetary situation in line with the plan for the resumption of gold payments. However, while Chandler argues that Strong also had good reason to favor lower rates in view of the domestic situation,<sup>11</sup> Wicker discounts domestic considerations. He argues that the recessionary tendencies apparent in the summer of 1927 were not sufficiently severe to warrant the actions taken, noting that production had taken "a much sharper dip . . . between September and December, 1926," and that, by July, when easing began, "the wholesale price index was rising for the first time in almost two years." Wicker suggests that the easy money policies of 1924 and 1927 were undertaken to establish the international gold standard and that in both cases the action merely "coincided with the goal of domestic stability."<sup>12</sup>

From a contemporary point of view, the test for monetary policy is economic performance, domestic and international. The United States had emerged from the war with its productive capacities stimulated rather than impaired and, thus, in a greatly strengthened position, both economically and financially, vis-a-vis Europe. In the immediate post-war period the economy was, however, crippled by the disastrous deflationary monetary policy of 1920 involving both a greatly decreased money supply and sharply higher interest rates. Again in 1923 tight money policies were pursued and an economic downturn resulted, though the policies were not nearly as restrictive and the resulting downturn nearly as severe as in 1920. After 1923 monetary policy was aimed primarily at achieving interest rate stability and financing real bills as against stock market loans. At times, however, policy was modified by the demands of Reserve banks for earning assets and by clear and strong evidence of recession in-process. But stability was foremost a financial rather than an economic objective in the 1920's, as is indicated by the somewhat deflationary impact of monetary policy even in the years after 1923.

The decade from 1919 to 1929 was an auspicious one for the banking system. The ratio of net profits to capital accounts averaged 8.0 percent for national banks and 8.5 percent for Federal Reserve member banks. Except for the decade at the turn of the century, this was the most profitable period for national banks since 1871.<sup>13</sup> The System prospered, it may be noted, though prices declined. By 1923, wholesale prices had recovered only one-sixth of the 45.9 percent drop sustained in 1920-21. From 1923 to 1929 they fell on the average of one percent per year, with an actual decline of about 8 percent between 1925 and 1929.<sup>14</sup>

Friedman and Schwartz cite the behavior of prices during this period as unique, but conclude that: "Apparently the steadiness of the price

<sup>11</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, p. 440.

<sup>12</sup> Wicker, *op. cit.*, pp. 109-110, 114-116.

Friedman and Schwartz take yet another view: "The System frequently cited foreign considerations as a justification for the general credit policies pursued. We are inclined, however, to agree with Hardy, who concluded that foreign considerations were seldom important in determining the policies followed but were cited as additional justification for policies adopted primarily on domestic grounds whenever foreign and domestic considerations happened to coincide." (Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton, N.J., Princeton University Press, 1963, p. 269).

<sup>13</sup> *Banking and Monetary Statistics*, pp. 260-261.

<sup>14</sup> Friedman and Schwartz, *op. cit.*, pp. 284, 298.

movement is far more important than its direction.”<sup>15</sup> The implication is that the period reflects a higher degree of monetary management and that this management was beneficial, and Friedman and Schwartz term the 1921–29 period, “The High-Tide of the Reserve System.”<sup>16</sup> There appears to be enough evidence to argue, however, that while the degree of monetary management was indeed greater, it was a question, rather, of the ability of a vigorous economy to surmount policies which were primarily financial and which, in another period, might have proved disastrous.

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<sup>15</sup> *Ibid.*, p. 242.

<sup>16</sup> *Ibid.*, Ch. 8.

## CHAPTER IX

### THE FAILURE OF MONETARY POLICY: 1928-29

In the late summer of 1927, a curious lack of congruity among economic indicators clouded monetary policy. Both production and factory employment continued to decline—(the trough of the recession that began in October, 1926 is November, 1927)—but wholesale prices and interest rates remained steady. Finally, there was a rise in speculative activity. Total member bank credit expanded \$1 billion in the last four months of 1927. Loans on securities accounted for 70 percent of the increase in total loans by member banks between September and December, a notable upsurge in November being reflected in a rising level of stock prices. A substantial volume of purchases were made by the Open Market Committee in August, 1927, and member bank indebtedness remained above \$400 million through November.<sup>1</sup> But after August there was no response from the System to either the continued decline in business or the rise in speculative activity. Reserve officials continued to focus primarily on interest rates which remained steady. At its November 1927, meeting, the Open Market Committee recommended:

. . . that the open market policy of the System until March 1st next, unless developments not now anticipated require a further review, shall be: to maintain stable rates for money at about present levels and prevent further imports of gold.<sup>2</sup>

In January, 1928 the Committee—or, more properly, the Federal Reserve Bank of New York—had second thoughts. It recognized that, despite stable money rates, economic conditions would lead to uncertainty in determining the future course of monetary policy. A memorandum prepared for the Committee at the New York Bank stated that:

It is not easy to explain the recent recession in business. There has been no general overproduction nor credit stringency . . . (In fact) in recent months the volume of credit has been increasing more rapidly than appears to have been required for the needs of business . . .

The memo, also noted that, “while the figures show a distinct recession in business” despite the easy-credit policy of 1927, “they do not show anything approaching a depression”; that “while industrial employment has decreased 5 or 6 percent since a year ago, there are no indications of serious unemployment”; and finally, that “the present almost unanimous opinion that business is likely to improve as the year advances appears to have some justification.” The real problem, the memorandum stated, was the rate of increase in the volume of bank credit, which “appears to have been much more rapid than was re-

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<sup>1</sup> Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, pp. 114, 116.

<sup>2</sup> Minutes of the Open Market Investment Committee, November, 1927, FBI File 333.b.2.

quired by the growth of trade this year in view of recessions in many branches of business.”<sup>3</sup>

As this statement implies, the real-bills doctrine continued to dominate monetary policy, and moreover, the issue of a qualitative approach to credit control was being revived within the System because of the rise in the use of securities as loan collateral. Governor Strong had a distinct aversion to qualitative tests and to the policy of moral suasion, and had succeeded in demonstrating the virtues of a quantitative approach through open market operations. But, as the memorandum reveals, officials at the New York Bank realized that the Federal Reserve would have to find some way of controlling the rise of bank credit for speculative purposes. The initial response from Governor Strong indicates that, as in 1920, he probably would have favored the quantitative approach involving an abrupt increase in rates to levels high enough to break the market boom, followed by an easing action of the magnitude undertaken belatedly in 1922. Strong died in October, 1928, and this maneuver was not actually proposed by the New York Bank until February, 1929.

### 1. Policy after the 1926-27 recession

While various proposals were being considered by the Open Market Investment Committee, other factions within the System had initiated an abrupt reversal of policy similar to the policies which were followed in the aftermaths of the recessions of 1920-21 and 1923-24. The Chicago and Richmond Banks raised their rates to 4 percent with Board approval on January 5 and 27 respectively. The discount rate went from a uniform 3½ percent at all 12 Banks at the beginning of 1928 to 5 percent at 8 of the Banks by August. In contrast discount rates *dropped* from 6 percent in the summer of 1921 to 4½ percent in the spring of 1922.<sup>4</sup>

Despite the magnitude of the shift, the Federal Reserve Board had acquiesced to the various proposed rate increases with reluctance. Both the Board and the Open Market Committee had agreed, early in January, on the need to work “towards somewhat firmer money conditions,” but had proposed sales of securities as an alternative to rate increases.<sup>5</sup> Between January 12 and February 1, 1928, \$150 million of assets were sold but, given the action of the Chicago and Richmond Banks, all the remaining banks except Cleveland raised their discount rates to 4 percent in February. The Board then opposed further sales. Nevertheless, in April the portfolio was reduced by an additional \$119 million and the action served as a prelude, not an alternative, to a further rate increase.

On April 18, the Boston Bank’s application for an increase to 4½ percent was approved. The Bank presented its case in terms of “local conditions,” but in citing member bank indebtedness, it was understood that the Boston directors felt rate increases were in order to curb stock market speculation.

The Richmond Bank followed with an increase to 4½ percent on April 4, but had already undertaken other actions which made its

<sup>3</sup> January 12, 1928 Memorandum to the Open Market Investment Committee. FRB File 333.b.2.

<sup>4</sup> *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, pp. 440-441.

<sup>5</sup> Minutes of the Open Market Investment Committee, January, 1928, FRB File 333.b.2.

position quite clear. On April 12, its board had voted to sell Richmond's participation in the Open Market Investment Account. Citing "country wide inflation of credit" and its conviction "that the National credit supply should be diminished," the Richmond board had resolved "to acquit themselves of further responsibility for continued credit expansion." In its communication to the Federal Reserve Board, Richmond stated that it had "freely sold" its portion of the System account "in an orderly manner," and would continue to sell "until the purpose is achieved, so far as such action can achieve it."<sup>6</sup>

At the Governors' Conference on May 1, 1928, Adolph Miller took the position that open market sales must be discontinued; that it would be preferable to raise the discount rate again, if necessary.<sup>7</sup> Nevertheless, open market sales continued, the Committee recommending that "it may still be necessary to exert further pressure on the credit situation . . ." By the end of May, the System account had been reduced to \$82 million and was further reduced to \$75 million as the Committee continued to sell into mid-July. The Committee's objective was to enforce the new discount rate by stabilizing rates at the higher levels. On June 28, J. H. Case, acting chairman of the Committee during Benjamin Strong's final leave of absence, wrote the new Board Governor, Roy A. Young, that:

. . . no real need exists for a meeting [of the Open Market Investment Committee] at this time . . . [since] the present scale of interest rates is likely to hold until the early part of July . . .<sup>8</sup>

While the Committee had thought its sales might be sufficiently effective to obviate the necessity for a further rate increase, the action had, as before, made an increase inevitable. On July 11, the Board approved a 5 percent rate at the Chicago Bank. Other Reserve banks followed: New York and Richmond on the 13th, Atlanta on the 14th, Boston and St. Louis on the 19th, and Philadelphia on the 26th. Cleveland raised its rate on August 1, while the remaining banks—Minneapolis, Kansas City, Dallas and San Francisco—maintained the 4½ percent rate into the early months of 1929.<sup>9</sup>

Although interest rates were rising rapidly, there was a substantial loss of gold during the first half of the year 1928 as European central banks felt compelled to raise their rates even higher. Given the gold outflow and the volume of sales from the System account, member bank indebtedness increased to over \$1 billion—the highest level since 1921. Many Reserve officials felt that pushing member banks indebtedness to this level had been beneficial in that there had been a definite decline in the rate of expansion of bank credit extended for brokers' loans. They had not yet realized that the decline had been more than offset by a tremendous increase in loan funds supplied by non-bank lenders—an increase of \$750 million in the first six months of 1928.<sup>10</sup>

Reserve officials did realize, however, that rising interest rates posed a problem. At the July, 1928 meeting of the Open Market Committee, the members drafted a statement of concensus which said that "present money rates would not be wholesome if continued over an extended period." Governor Seay of the Richmond Bank disagreed. In a letter

<sup>6</sup> Letter from Governor George J. Seay to Governor Young, April, 1928. FRB File 333.b.1.

<sup>7</sup> Wicker, *op. cit.*, p. 121.

<sup>8</sup> Minutes of the Open Market Investment Committee, May, 1928. Letter from J. H. Case to Governor Roy A. Young, June 28, 1928. FRB File 333.b.2.

<sup>9</sup> *Banking and Monetary Statistics*, p. 441.

<sup>10</sup> Wicker, *op. cit.*, p. 121.

to the new acting chairman of the committee, George Harrison, on August 20, he wrote: "Nobody can contend that business in the aggregate has been hurt by current high rates for money because business has improved." Seay explained that interest rates were rising because businessmen themselves were speculating. Cautious and conservative, he represented the views of a large faction in the banking community when he argued that:

... the situation should remain such as to compel its release by those who have absorbed credit for other than business purposes rather than putting more Federal Reserve funds into the market ...<sup>11</sup>

## 2. Prelude to depression

As Governor Seay noted, business had improved. Despite a 5 percent increase, however, production still fell below the level of the winter of 1926-27.<sup>12</sup> More significantly, employment fell in June, 1928 to the lowest level since 1924. Unemployment, which had been 4.1 percent for 1927—the year in which the recession occurred—rose to 4.4 for the year 1928.<sup>13</sup> Evidence of a continuation of recessionary tendencies troubled those Reserve officials who anticipated a further reduction in business inventories as a result of high rates. Edmund Platt, vice-governor of the Federal Reserve Board, wrote Governor Young in July, 1928:

My own feeling is that no one can tell at this time just what may be indicated as the right thing to do at that time [the fall]. I feel that we have gone a little further than necessary in selling Government securities.<sup>14</sup>

The Board as a whole and the Open Market Investment Committee agreed that some action should be taken if strain were to develop. But purchases of Government securities were viewed as a last resort and limited to \$10 million. The Philadelphia Bank protested the inadequacy of this policy and recommended "that the purchase of bills and Government securities be resorted to without waiting for an emergency." Its board of directors were of the opinion that "the policy of the System should be directed to the helping of commerce and business."<sup>15</sup> The Board agreed that a little less restraint would be a good thing and authorized the Reserve banks to purchase acceptances rather freely and without an increase in the buying rate. The emphasis on purchases of acceptances rather than Government securities reflects the prevailing real bills notion that the proceeds from such purchases would go directly to legitimate business rather than the stock market. Regardless, there were no changes in discount rates or in the System portfolio of Government securities for nearly a year—from August 1928 to July, 1929. Between August and November, 1928, however, the Reserve banks bought \$300 million of acceptances, and bought \$171 million more in November—the largest amount in any month since March, 1920.<sup>16</sup>

The purchase of acceptances had been Governor Young's idea. He, too, was under the impression that the money released would go into

<sup>11</sup> Minutes of the Open Market Investment Committee, July, 1928. Letter from Governor George J. Seay to Deputy Governor George L. Harrison, August 20, 1928. FRB File 333.b.2.

<sup>12</sup> Wicker, *op. cit.*, p. 123.

<sup>13</sup> *Historical Statistics of the United States, Colonial Times to 1957*, House Doc. No. 33, 86th Cong., 1st Sess., p. 73.

<sup>14</sup> Letter from Edmund Platt to Governor Roy A. Young, July 18, 1928. FRB File 333.b.2.

<sup>15</sup> Letter from Governor Young to Deputy Governor George L. Harrison, August, 1928. Letter from Governor Norris to Governor Young, August, 1928. FRB File 333.b.2.

<sup>16</sup> Wicker, *op. cit.*, p. 125.

commercial loans rather than into the stock market, and failed to appreciate fully the relationship between the purchase of bills, open market rates and call money rates. Formerly the governor of the Minneapolis Bank, his views tended to conform to those of a majority of Reserve bank governors who felt safer within the confines of more passive definitions of the System's function. Elevated to the governorship of the Board in 1927, his views are critical in assessing the performance of the System in 1928 and 1929. A significant expression of those views was recorded by E. A. Goldenweiser in a comment on a conversation he had with Governor Young on March 6, 1929. Goldenweiser wrote:

I think that fundamentally what he has in mind is not that the Federal Reserve banks can't do it, but that his instinct is that on the whole the Federal Reserve banks will do best if they adjust themselves to events, rather than trying to shape them. I have sympathy with that position, but there are times when leadership is essential.<sup>17</sup>

Meanwhile, in January, 1929, leadership was assumed by Adolph Miller who, with the support of Charles H. Hamlin, another Board member, reinstated the policy of "direct action," or moral suasion, which they had favored in 1919. The idea was to encourage discounting by member banks for legitimate commercial needs while discouraging borrowing "either for the purpose of making speculative loans or for the purpose of maintaining speculative loans."<sup>18</sup> Those who favored "direct action" were concerned about the effect of current high rates on business but did not feel that the System could relax its tight money policy until there had been a substantial reduction in the amount of Federal Reserve credit extended for brokers' loans. Direct action was seen as an alternative to rate increases.

As in 1919, this policy was opposed by the New York Bank which held that it was not possible to make clear-cut distinctions as to the purpose of member bank borrowing from the Reserve banks, that the only effective test of credit control was in terms of the total amount of Federal Reserve credit outstanding, and that the way to curb speculation was to raise the discount rate. As an alternative to direct action, Governor Harrison argued on February 7, 1929 for a sharp increase in the discount rate—followed by a policy of ease—to bring the total volume of credit under control as quickly as possible. Elmus R. Wicker notes that this policy had also been proposed by Governor Norman of the Bank of England during his visit to New York and Washington a week or so before. The Board was unwilling to adopt such a program because it did not think the market could be broken without bringing on a business recession.<sup>19</sup>

During the period in which the policy of direct action was tried—from about mid-February to mid-May, 1929—loans to brokers declined by \$650 million at reporting member banks, stock prices fluctuated in a narrow range, and Miller and Hamlin argued that the policy was a success. While the policy of direct action may have contributed, contrary to its intention, to a rise in rates—the rate on prime commercial paper advanced from 5.38 percent in January to 6 percent in

<sup>17</sup> Conversation between E. A. Goldenweiser and Governor Young, March 6, 1929. (*Goldenweiser Papers*, Library of Congress, quoted by Wicker, *op. cit.*, p. 131).

<sup>18</sup> *Stateventh Annual Report of the Federal Reserve Board* (1929), p. 3.

<sup>19</sup> Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton, N.J., Princeton University Press, 1963, p. 257. Wicker, *op. cit.*, p. 134.

June—the action of the New York Bank was the primary factor. In January, New York had raised its buying rate for bills to encourage a seasonal run-off and the result was a hefty \$375 million decline in Federal Reserve bank purchases of bills over the first six months of the year.<sup>20</sup> Undoubtedly this sharp drop in purchases of bills contributed to the decline in bank loans to brokers. Moreover, the action of the Bank of England in raising its discount rate at the time must have made a significant contribution toward achieving this objective. However, the question of which policy was, or could have been, more effective is irrelevant in assessing the total volume of credit extended to the stock market during this period. As had been the case in 1928, the restrictive action merely accelerated the flow of funds to the market from non-bank sources.

Relations between the New York Bank and the Board had been strained since New York raised the buying rate for bills at the beginning of January, 1929, contrary to Governor Young's wishes and without consulting the Board. On February 14, the New York Bank voted to recommend an increase in its discount rate to 6 percent, informed the Board by telephone, and demanded an immediate decision.<sup>21</sup> The Board rejected the proposal as unnecessary in view of its policy of moral suasion. The New York Bank submitted its application for a rate increase on ten subsequent occasions between March and late May. Intermittently, the Boston, Philadelphia and Chicago Banks also petitioned for rate increases and were turned down.

The Board's refusal to permit an advance in discount rates reflects the fact that even those who had little hope for moral suasion—notably Governor Young and Vice Governor Platt—were willing to give it a chance. By May, these two and Secretary Mellon formed a minority voting for rate increases. On May 22, officials of the New York Bank appeared before the Board to argue for its rate increase proposal. Their main point was that the only effect of direct action had been to drive the member banks to borrow outside the System at higher rates. A more intransigent view was expressed in a memorandum to Governor Young from Gates McGarrah, chairman of the board of the New York Bank and Federal Reserve agent, on May 31, 1929. McGarrah argued that it was necessary to "correct the widely understood intimation of the Federal Reserve Board that collateral loans are not a proper function of legitimate banking."<sup>22</sup>

June and July passed without a change in policy. A majority of the Federal Reserve Board still believed that the policy of moral suasion was effective and was in effect. The Reserve bank governors had voiced opposition to the policy in April and a majority had gone on record as favoring an advance in discount rates. By June, however, they were less committed to the idea of a rate increase despite overwhelming evidence that the speculative fever was unchecked. In view of coming seasonal pressures as well as popular resentment against any action that might topple a now spectacular speculative structure, they no longer felt the System should undertake to raise its discount rates without simultaneously otherwise providing a greater

<sup>20</sup> Wicker, *op. cit.*, p. 135, *Banking and Monetary Statistics*, pp. 444, 450.

<sup>21</sup> For a more complete account of this episode, see Friedman and Schwartz, *op. cit.*, pp. 258-259.

<sup>22</sup> Quoted by Wicker, *op. cit.*, p. 140.

degree of monetary ease. There is, then, some question as to whether or not the System's effort to curb borrowing for speculative purposes by refusing accommodation was implemented with any real force during the early summer of 1929.

The policy which Governor Harrison proposed in June and which was put into effect in August reflected the conceptual framework of the Reserve bank governors and those on the Board—notably Young, Platt and Secretary Mellon—who shared their views. They believed that restrictive action by the System should be conducted with whatever care necessary to avoid a financial crisis, although how the market could have been broken at this point without an ensuing stock market crisis is difficult to understand. They were, however, convinced that it was necessary to dampen speculative pressure. Had there been legislation permitting the Federal Reserve System to set stock margin requirements, the problem would have been simpler. Harrison's proposal called for an increase in the discount rate at the New York Bank, a reduction in the buying rate for bills to encourage an enlarged volume of purchases by the Reserve banks, and an authorization for purchases of Government securities if necessary. The Board turned down the proposal initially but, under pressure at its Joint Conference with the governors in August, finally approved the request of the New York Bank for a rate increase.<sup>23</sup>

The discount rate was raised to 6 percent at the New York Bank on August 9, 1929, but the 5 percent rate remained in effect at the other Reserve banks. Simultaneously, New York lowered the minimum buying rate for bills from  $5\frac{1}{4}$  to  $5\frac{1}{8}$  percent and between August 7 and October 23, the Reserve banks purchased \$300 million of acceptances.<sup>24</sup> This period encompasses the peaking of the "bull market" to the decline which climaxed abruptly on the 24th of October, Black Thursday. On October 29, it became necessary to take further action and, without waiting for an authorization, Governor Harrison bought \$132 million of Government securities.

Harrison was prepared to follow up the purchases of October 29 with additional purchases of up to \$200 million. The Board, however, refused to authorize further open market operations at this point, believing that the System should emphasize a liberal discount policy. Accordingly, the New York Bank's discount rate, which had been lowered from 6 to 5 percent on November 1, was lowered again to  $4\frac{1}{2}$  percent on November 15. The Boston and Chicago banks also lowered their rates to  $4\frac{1}{2}$  percent on November 21 and 23, and four other Reserve Banks followed in December. Meanwhile, Harrison used an earlier authorization to purchase approximately \$100 million of Government securities for the System account between October 20 and November 20, and in December, having gotten a new authorization from the Board, the Committee bought \$155 million more. There were no further purchases of securities until March, 1930.<sup>25</sup>

### 3. *Money supply: early 1928 to mid-1929*

Monetary policy is often evaluated by changes in the quantity of money. Actual growth rates in the money stock reflect both economic

<sup>23</sup> Minutes of the Joint Conference of Governors with the Federal Reserve Board, August 7, 1929, pp. 1f. FRB File 333.b.2.

<sup>24</sup> Wicker, *op. cit.*, p. 142.

<sup>25</sup> *Ibid.*, p. 145. *Banking and Monetary Statistics*, p. 441.

events (money demand) and policy (money supply). In principle, however, the Federal Reserve has always had sufficient power to make the growth rate whatever it wished, if not from week-to-week, certainly over a year. The Federal Reserve has often failed to use this power, choosing instead to act upon interest rates and other credit variables, and thus money supply growth rates often emerged as a result of the interaction of the Federal Reserve's credit policies and the economic trends influencing money demand. Nevertheless, the growth rate of the money stock is an important indicator of monetary policy, for it can in principle be controlled. A growth rate below 2 percent per year is considered dangerously depressionary if it continues for very long. In the period before the great depression this was allowed to happen. The money stock reached \$26.6 billion in April, 1928, five months after the 1926-1927 recession. It fell below this level until July, 1929 when it reached \$26.7 billion. In August and September it fell back first to \$26.5 and then to \$26.4 billion. The stage was thus set.

## CHAPTER X

### THE BEGINNING OF THE DEPRESSION: 1930-33

It is doubtful that yet another detailed examination of the actions of the Federal Reserve System during the early years of the Depression would contribute to the understanding of monetary processes. It would appear more useful to examine the institutional disarray which ensued. That this confusion represented a structural weakness in the System and not merely the "state of the art" is a view expressed a generation later by Professor Milton Friedman:

So far, I have listed two main technical defects of an independent central bank from an economic point of view; first, dispersal of responsibility, which promotes shirking in times of uncertainty and difficulty, and second, an extraordinary dependence on personalities, which fosters instability arising from accidental shifts in the particular people and the character of the people who are in charge of the system.<sup>1</sup>

#### *1. Triumph of the real bills doctrine*

The conditions which Professor Friedman describes all but assured that the System would not assume an active role in seeking means to alleviate the economic disaster which followed the crash. It had assumed a quasi-legislative function in defining its own structure, and was in the process of reorganizing the open market mechanism during the early months of 1930. Since the decision to replace the Open Market Investment Committee with one which would include all 12 Reserve bank governors was made in the latter part of 1928, the timing appears to have been accidental, but the effects of the change were not. In 1935, the House Banking and Currency Committee was to describe the Open Market Policy Conference as a body "authorized to formulate policies but not to put them into effect." The House Committee noted that approval for a given policy was required of a majority of the Board and of the 108 directors of the 12 Reserve banks, with any one or more of the banks having the right to decline to participate in transactions. It commented that:

It would be difficult to conceive of any arrangement better calculated than this for diffusing responsibility and creating an elaborate system of obstructions.<sup>2</sup>

Although Congress had specified its intention that the policy-making body within the System not be dominated by a banking point of view,<sup>3</sup> creation of the Open Market Policy Conference assured that the opposite would occur. The 12 governors of the Reserve banks now

<sup>1</sup> Milton Friedman, "Should There Be An Independent Monetary Authority?": *In Search of A Monetary Constitution*, Leland B. Yeager (ed.), 1962. Inserted in *The Federal Reserve System After Fifty Years*, hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Cong., 2nd Sess., Vol. 2, p. 1172.

<sup>2</sup> H. Rept. No. 742 to accompany H.R. 7617, 74th Cong., 1st Sess., April 19, 1935, p. 10.

<sup>3</sup> The specification in the original Federal Reserve Act of 1913 that 2 members of the Board be "experienced in banking or finance," was a concession to the banking lobby which had fought to have bankers dominate the System's management. Debate on this section (section 10) indicated, however, that it was intended that no more than 2 of the 7 members of the Board be bankers. In 1922, an 8th member was added to the Board, to represent agricultural interests, and in 1935, the requirement that 2 members be experienced in banking or finance was removed altogether.

had an equal voice with the Federal Reserve Board in making policy and could control its implementation more effectively than could the Board. The governors were all drawn from the banking community and were indirectly selected by the member banks. They were totally independent of the Board or of any other Government agency. With the enhancement of their position *vis-a-vis* the Board, the System tended to resemble a bankers' cooperative of the sort described in the 1912 Aldrich central bank proposal.

With the ties between the System and the banking community drawn tighter, the point of view narrowed considerably. The real bills doctrine which, though discredited by the bitter experience in 1920–1921, continued to influence policy throughout the 1920s, emerged now almost unchallenged as the doctrinal basis for decision-making by the System. The result was catastrophic. Because the needs of trade were down and declining, the emphasis of monetary policy was on liquidation. While many saw the System's policies as actively favoring the creditor at the expense of the debtor, to Reserve officials it seemed merely a matter of safety, of protecting the banking system from making illiquid unsound loans. Unfortunately for both the economy and the banking system, the choice of such a framework for policy did positive harm. Aside from prescribing a passive, non-interventionist role for the System, it led to contraction rather than expansion of the money supply. The money stock declined from \$26.7 billion in July, 1929 to \$19.1 billion in July, 1933.

In retrospect, it is generally conceded that the System could have made no more drastic error in judgment except to raise the discount rate. Unfortunately, it did that, too, in the fall of 1931. Most commentators have held that the System's errors were due to ignorance. Still, as Elmus R. Wicker has noted, there had been almost no change in the management of the individual Reserve banks,<sup>4</sup> and thus both the successes and the failures of the previous decade should have served as precedents for action. Moreover, there were many proposals for countercyclical operations. Their rejection reflects a loss of confidence rather than ignorance. The System no longer acted as an independent agency capable of exerting leadership and formulating policy. Reacting to failure, it was content merely to assume the intellectual myopia of others. Because of its structure at this point in its history, it assumed an obligation to represent the member banks and to reflect the concensus view of the financial community. Thus the triumph of the real bills doctrine. It could be argued that the choice of any other special interest group as a constituency would have led to policies no less beneficial to the public at large. But the point is that the myopia of the banking community is the real bills doctrine and that using it as the basis for determining monetary policy is disastrous, leading to overexpansion of money and credit in inflation and to catastrophic liquidation when the needs of trade decline as they did after 1929.

## 2. *Résumé of policy*

The fact that the System had rejected a countercyclical policy became apparent in the spring of 1930. Reductions in discount rates had

<sup>4</sup> Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917–1933*, New York, Random House, 1966, p. 195.

resumed in February and by March, the New York Bank had lowered its rate to 3½ percent with rates of 4 and 4½ percent at the other Reserve banks. At the March meeting of the Open Market Policy Conference, Governor Harrison of the New York Bank made no effort to press for a large volume of purchases of government securities and a majority of Reserve officials indicated an unwillingness to purchase even a small amount. As a result, purchases of only \$50 million followed. In June, the Conference again authorized purchases of \$50 million. Meanwhile, there were further reductions in discount rates and by August, ten of the Reserve banks had 3½ percent rates, the Boston Bank had lowered its rate to 3 percent and New York's rate was down to 2½ percent.<sup>5</sup>

By September, 1930, it was clear that there would be no substantial deviations from the old "needs of trade" doctrine. Prior to the September 25, 1930 meeting of the Open Market Policy Conference, Governor Harrison circulated a proposal advocating countercyclical operations, but not involving "any very large amount" of purchases. In view of Harrison's belief that "the seriousness of the present depression is so great," it was a modest proposal.<sup>6</sup> Nevertheless, a majority of the Reserve bank governors opposed it and it was voted down at the Con-

<sup>5</sup> *Ibid.*, pp. 150, 152, *Banking and Monetary Statistics*, Washington, D.C., U.S. Board of Governors of the Federal Reserve System, 1943, p. 441.

Governor Harrison's views at the beginning of the year were expressed in a letter to Governor Black of the Atlanta Bank on January 10, 1930:

"... there is no need at this time for any further purchases of Government securities. On the other hand, there are a number of factors in the situation which make us believe that there is no need just now for any sales from the System account . . ." (FRB File 333.b.1.)

<sup>6</sup> Memorandum from Governor George L. Harrison, addressed to all 12 Reserve bank governors, July 3, 1930. FRB File 333.C.1.

The following are further excerpts from this memorandum:

"... I write to you outlining some of the reasons why the Federal Reserve Bank of New York has for so many months favored having the Federal Reserve System do everything possible and within its power to facilitate a recovery of business."

"They do feel, however, that further purchases of Government securities in circumstances such as the present can do no possible harm and will likely accomplish some good.

"As they view the situation it is about this: The United States and most other countries of the world are in the midst of a severe business depression. The decline in business activity has been great as judged by almost every available index. Unemployment is serious."

"While it is no doubt true that this depression is, in part at least, the result of causes quite unrelated to monetary conditions and clearly outside the control of the Reserve System, there are nevertheless some aspects of the situation with respect to which the Reserve System has a direct responsibility . . . it is also true that underconsumption, due to credit restrictions and high rates during 1928 and 1929, a stoppage of the flow of capital, and an interruption of economic activity in many sections of the world, has also been an important factor in the present depression."

"Anything, therefore, that can be done to stimulate economic activity and thus provide a market for that surplus, however great or however small, will be a steady influence and a vital factor in the recovery of prices and business."

"In previous business depressions recovery has never taken place until there has been a strong bond market through which new enterprise requiring long time capital may be financed. So while there is no considerable demand from business for short time money at the present time, and short time money may be said generally to be plentiful and cheap in many sections of the country and other parts of the world, there is nevertheless a large demand for long time capital for new undertakings. The bond market has in the past several months been able to absorb a very considerable volume of these new issues but it is not yet vigorous nor is it able to supply all of the funds which legitimate business, both at home and abroad, so much demands."

"This may not involve any very large amount of further purchases, but our directors feel that additional purchases at the present time are not only desirable but necessary if the System is to do its utmost for the accommodation of business and trade.

"So while there may be no definite assurance that open market operations in Government securities will of themselves promote any immediate recovery, we cannot foresee any appreciable harm that can result from such a policy and believe that the seriousness of the present depression is so great as to justify taking every possible step to facilitate improvement."

ference. The view of the majority was reflected in a memorandum read to the Conference by Governor Norris of the Philadelphia Bank:

We have always believed that the proper function of the System was well expressed in the phrase used in the Tenth Annual Report of the Federal Reserve Board (1923)—“The Federal Reserve supplies the needed additions to credit in times of business expansion and takes up the slack in times of business recession.” We have therefore necessarily found ourselves out of harmony with the policy recently followed of supplying *unnneeded* additions to credit in a time of business recession, which is the exact antithesis of the rule above stated. [Emphasis supplied.]

The genesis of this return to the “real bills” doctrine is nicely expressed in the remorseful homily that followed:

The consequences of such an economic debauch are inevitable. We are now suffering them. Can they be corrected or removed by cheap money? We do not believe that they can. We believe that the correction must come about through reduced production, reduced inventories, the gradual reduction of consumer credit, the liquidation of security loans, and the accumulation of savings through the exercise of thrift. These are slow and simple remedies, but just as there is “no royal road to knowledge,” we believe that there is no shortcut or panacea for the rectification of existing conditions. We do entertain, however, the belief that the declines of commodity prices and in employment have about run their course and that the foundations for business revival have already been laid.

The same Governor Norris who first proposed countercyclical operations in 1921, fought the Treasury’s policy of sales in 1923 and had recommended in August, 1928 “that the purchase of bills and Government securities be resorted to without waiting for an emergency,” continued:

This (countercyclical) policy has interfered with the operation of the natural law of supply and demand in the money market, and has created artificially low interest rates, and artificially high prices for government securities. It is open to the same objections which the Treasury urged in 1922 to the purchase of governments which the Federal Reserve Banks were making at that time. *It is an injustice to our member banks.* [Emphasis supplied.]<sup>7</sup>

Consistent with the real bills doctrine is the notion that central banks should use interest rates as the target of monetary policy—the vehicle for transmitting their actions to the economy. Thus, expansion of credit and money was justified even in inflation provided rates were high, and conversely, contraction of credit and money was, if not justified, at least not to be resisted even in a general economic downturn if rates were low. Bagehot’s so-called golden rule of central banking would not be violated in either case. The Open Market Policy Conference of September, 1930 voted to focus on interest rates, without recognizing or at least noting the fact that it violated countercyclical policy given prevailing trends. The manager of the account was authorized to buy or sell up to \$100 million of securities, “to maintain the present easy money rate position in the principal money centers,” with the restriction that “further easing” be avoided.

<sup>7</sup> Minutes of the Open Market Policy Conference, September 25, 1930, pp. 1, 2 and 4. FRB File 333.C.2. See also footnote 15, chapter IX.

In his memoirs, former President Herbert Hoover describes these views as belonging to a school of thought—the “leave it alone liquidationists”—headed by Secretary of the Treasury Andrew Mellon:

“... who felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: ‘Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.’ He insisted that, when the people get an inflation brain-storm, the only way to get it out of their blood is to let it collapse. He held that even a panic was not altogether a bad thing. He said: ‘It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people.’” (*The Great Depression, 1929-1941, The Memoirs of Herbert Hoover*, New York, The MacMillan Co., 1952, p. 30).

Adolph Miller argued against this policy directive on the grounds that, "in times of depression, particularly, a money rate is a very imperfect indicator of the true state of credit." He told the Conference:

. . . Money is sleeping and it is conceivable that a part of a constructive program is to wake it up and make it do something and that you may be misled into a false sense of the soundness of the general money situation because rates are low.<sup>8</sup>

Miller's attempts to galvanize the System were met with resistance in another form as well. Most officials refused to acknowledge the gravity of the situation and saw an upturn in business "just around the corner." Miller, however, sensed a pessimism so pervasive as to preclude a constructive effort. As he told the governors: "You accept the fact that the present depression at this time has reached a point beyond the remedial measures of a credit policy alone."<sup>9</sup> The Minutes of the August 4, 1931 meeting of the Conference's executive committee illustrate the accuracy of the insight:

. . . Governor Harrison summarized the position with regard to purchases of governments by saying that, admitting the world was in the midst of a social, economic and political crisis, the question was whether there was anything the Federal Reserve System could do. If by the purchase of Government securities it could facilitate an increase in world prices, clearly it should be done. It is doubtful whether a purchase of governments would have such an effect, at least immediately, but the question is whether in the present crisis, which involves perhaps a struggle between socialism and capitalism, the System can wisely omit doing anything which might be helpful and which a growing number of responsible people believe would be helpful.<sup>10</sup>

In view of the attitude of helpless uncertainty which this statement reveals, it is understandable as a psychological reaction that Reserve officials would jump at the opportunity to make an orthodox response. The decision to raise discount rates in October, 1931—from 1½ percent to 3½ percent at the New York Bank—followed the conventions of sound central banking practice and proved them to be, as Benjamin Strong had discovered precisely a decade earlier, inappropriate in the

<sup>8</sup> Minutes, OMPC, September 25, 1930, pp. 5, 9-14.

Adolph Miller had not favored an aggressive open market policy during the 1920's but tended to accept a countercyclical orientation which relied on rate levels. He and Senator Robert Owen had argued in 1920 that inflation be controlled by increasing production and introduced the policy of "moral suasion" to control lending for speculative purposes. Such a policy required that rates be stabilized at relatively low levels.

As a member of the original Board appointed by President Wilson in 1913 who served continuously until the Board's reorganization in 1935, Miller played an important role in the System's early development. He was overshadowed by Benjamin Strong and the clash of personalities and struggle for control may well have distorted Miller's development as a monetary theorist. Even so, his analytic approach made a significant contribution to the intellectual history of the System. While not an active innovator, he was as quick as Strong to sense obsolescence.

During the early years of the depression, Miller was probably the only official within the System who was qualified to make policy recommendations. In August, 1931, he made a special plea for "bold, experimental use" of open market operations, "skeptical as he might be toward Open Market Policy as an instrument of the Federal Reserve System" (Minutes of the OMPC, August 11, 1931, p. 6, FRB File 333.C.2). He joined Secretary Mills in pressing again for action at the April 12, 1932 Conference (Minutes, p. 2, FRB File 333.C.2); favored the purchases made in that year, but saw the need for action on a broader scale—in terms of direct Government assistance to industry rather than reliance on the credit system alone (Minutes, OMPC, May 17, 1932, p. 5, FRB File 333.C.2). In March 1933, he urged the Board to support President Hoover's suggestion for issuing clearing housing certificates—not an original idea, but a means by which the Board might have acted to head off the crisis. When the Board postponed a decision on the matter and, in effect, declined to take any action, Miller commented "that this inertia made him feel that the whole Board should be reorganized." (Wicker, *op. cit.*, p. 191).

Unfortunately for the country, Miller and Hoover had much in common. Both were thoughtful and intelligent men, capable of constructive suggestion. Their common weakness was a tendency to acquiesce to a role in which they constantly urged that action be taken by others.

<sup>9</sup> Minutes, OMPC, September 25, 1930, p. 11, FRB File 333.C.2.

<sup>10</sup> Minutes of the Executive Committee of the OMPC, August 4, 1931, p. 2, FRB File 333.C.2.

context of economic policy. As the Minutes of the January 1932 meeting of the Conference observed, the results were a further decline in business activity and employment, in commodity prices, in security prices and in bank credit, with a further increase in bank failures. Nevertheless, the Executive Committee reported cheerfully that:

The heavy gold outflow of the early autumn has been followed by a renewed inflow, so that the monetary gold stock of the United States is only about \$135,000,000 smaller than a year ago.<sup>11</sup>

In January, 1932, the System began gradually to reduce discount rates but did not permit rates to decline to levels as low as those of September, 1931—when the rate at the New York Bank was 1½ per cent—until February, 1934. Meanwhile, in January, 1932, the Open Market Policy Conference reopened the question of taking action and, in view of the continuing decline in business, employment, etc., authorized the Executive Committee to purchase \$200 million of securities if necessary. Apparently the conditions which would constitute a situation of necessity were not made clear or did not occur. No substantial purchases were made and, at the April 12, 1932 Conference, the administration informed the System that its patience had been exhausted:

Secretary Mills, who had entered the meeting after it had begun stated that he believed a great duty now rested on the Federal Reserve System; that Congress and the Administration had done all they could in developing remedial action, and yet deterioration was taking place steadily. For a great central banking system to stand by with a 70% gold reserve without taking active steps in such a situation was almost inconceivable and almost unforgivable. The resources of the System should be put to work on a scale commensurate with the existing emergency.<sup>12</sup>

In the face of this political pressure, it was agreed that the system should make purchases of up to \$500 million of governments. The amount suggested was approximately the same amount that had been purchased by the System during the mild recessions of 1923-24 and 1926-27. In May, however, the Conference voted to authorize purchases of an additional \$500 million and between mid-April and mid-June 1932 approximately \$850 million were bought.<sup>13</sup> At this point, the System encountered a new problem. Despite the substantial additions to reserves, member banks were unwilling to either expand their loans or repay their borrowings to the System. The System's purchases created excess reserves held as cash balances by a majority of member banks who chose to protect their liquidity. System officials did not understand and gave up. This was unfortunate. Banks' demand for excess reserves clearly had risen but probably had not become indefinitely large. Though we can never know, it seems reasonable to believe that the System could have increased its purchases sufficiently to satisfy banks' demands for liquidity and more—to stimulate loan expansion and expansion of the money stock and business activity as well.

At the June 16, 1932 meeting of the Conference, it was decided to make purchases under the unexpired authorization in small amounts—just enough—

<sup>11</sup> Memorandum from the Executive Committee of the OMPC, January 8, 1932, pp. 1-2. FRB File 333.C.2.

<sup>12</sup> Minutes, OMPC, April 12, 1932, p. 3. FRB File 333.C.2.

<sup>13</sup> Wicker, *op. cit.*, p. 182.

. . . to show an increase from week to week in total holdings of Government securities in order to avoid the creation of a feeling that the policy of the system had been changed, but that such increases should be in amounts as small as might be, to preserve these excess reserves and take care of special conditions arising from week to week.<sup>14</sup>

The Conference authorized purchases of an additional \$200 million of governments at the July 14 meeting, but again purchases were to be made in small amounts over a period of time. By August 10, purchases had ceased. As the Executive Committee's report of November 14, 1932 stated:

. . . it was no longer necessary to make further purchases of Government securities for the System account in execution of the program, adopted at that time, and purchases under that program totaled only \$30,000.<sup>15</sup>

The minutes of the November 15, 1932 meeting of the Open Market Policy Conference read as follows:

All of the Members of the Conference were of the opinion that there is no occasion to buy more securities at the present time. The question for the decision of the Conference, therefore, was whether the System should now sell some of its present holdings or leave the account stationary.<sup>16</sup>

The fact that all the Members of the Conference agreed that no further purchases were necessary seemed to vindicate those who had opposed the policy. In such an atmosphere, a proposal for sales was more than a hypothetical alternative. The real bills framework as a guide to policy justified sales. Further, a majority of Reserve officials were unhappy with the level of excess reserves which, they halucinated, might suddenly become the basis for a runaway inflation. Fortunately, the administration continued to put pressure on the System to take constructive action despite its defeat in the November elections, and was probably responsible for preventing an abrupt reversal of policy.<sup>17</sup> As it was—with no decisive action taken—there was further deterioration.<sup>18</sup> What was probably the bottom of the depression was reached in the first quarter of 1933, together with a collapse of the banking system.

<sup>14</sup> Minutes, OMPC, June 16, 1932, p. 2. FRB File 333.C.1.

<sup>15</sup> Report of the Executive Committee of the OMPC, November 14, 1932, p. 1. FRB File 333.C.2.

<sup>16</sup> Minutes, OMPC, November 15, 1932, p. 1. FRB File 333.C.2.

<sup>17</sup> There are numerous accounts of President Hoover's refusal to take responsibility for declaring a banking holiday without the concurrence of President-elect Roosevelt. It should be noted, however, that between November and February, Hoover sent a steady stream of communications to the Federal Reserve Board pressing for action and requesting advice on various proposals, such as a Federal guarantee for bank deposits. The Board refused to act or to support any of the various proposals suggested until, in the final moments of his administration, they suggested to the President that a banking holiday be declared. Hoover's sense of frustration, as revealed in the letter he wrote Governor Eugene Meyer on March 3, seems imminently justified. (The letter and an account of the relations between the President and the Board may be found in Wicker, *op. cit.*, pp. 184-195). In his Memoirs he concluded that the Board "was indeed a weak reed for a nation to lean on in time of trouble." (Hoover, *op. cit.*, p. 212.)

<sup>18</sup> Actually the System did sell some securities to offset the return flow of currency. The result was a weakened long-term bond market. A target level for excess reserves was chosen, however, and again the System was careful to maintain the appearance that no change in policy had occurred. (Wicker, *op. cit.*, p. 185.)

## PART III

### CONCLUSIONS

#### CHAPTER XI

##### THE EVOLUTION OF FEDERAL RESERVE INDEPENDENCE

Proponents of independence for the Federal Reserve System have always argued that the success of monetary policy depends on the absence of political pressure. Indeed, devices for insulating the System from political pressure were debated and incorporated into the enacting legislation in 1913. Implied in such an arrangement is the suspicion that a political institution such as the Federal Government has interests which do not always coincide with the public interest. It has been argued that monetary policy in 1928—the balancing of an increase in discount rates against large purchases of acceptances—reflects some response to the presidential election of that year. But this hypothesis appears far-fetched. The System's 1928 policy was consistent with and indeed a natural corollary of the real bills doctrine—the theoretical base of monetary policy, as was earlier discussed. On the other hand, the behavior of the System during the early years of the depression indicated to some that there was no guarantee that the System would act in the public interest except as the result of political pressure. This argument appears less remote.

Whether beneficent or not, political or popular pressure would appear to be inevitable given the impact and significance of the System's actions. Moreover, if or whenever this is not the case, there are other more parochial forces which shape monetary events. The System has seldom been able to ignore the vital interests of its member banks, even when their needs are at odds with the interests of the nation as a whole. Further, the structure of the System encouraged internal conflicts (for example, between the Board and Reserve bank governors) which, because of the aversion of Reserve officials to Congressional supervision, were never settled by appeal to a higher authority. Thus, the problem of determining the responsibility of officials who were not truly elected or appointed compounded the lack of a clear-cut mandate for policy objectives. Finally, as economic events in the United States interacted more obviously with events abroad, international problems exerted an increasing influence on monetary policy. While it should be noted that here, more than in these other instances, no real conflict of interest could be involved, intensive but somewhat secretive consultations between System officials and foreign central bankers in the late 1920's fed the suspicions of a growing number of people who thought American prosperity and stability were sacrificed to overseas interests and "international capitalism."

#### *1. The triumph of interest rates as the target variable and the forces influencing interest rate policy*

A recapitulation of some events of the 1920's in the context of the political environment which shaped them may be useful in tracing the development of Federal Reserve independence and indicating some

of its drawbacks. The argument for an independent System was made by Governor W. P. G. Harding of the Board, Secretary of the Treasury Andrew Mellon, and Governor Benjamin Strong of the New York Bank in various appearances before Congressional Committees during the 1920's. The appeal was for freedom from Congressional as well as administrative intervention with Secretary Mellon's testimony, paradoxically in view of his own efforts to influence System policy, offering assurances of the administration's disinterest. It helped to defeat the so-called stabilization bills of the period which would have constrained the System with a Congressional directive making price stability the target for System policy. The result of this defeat for Congressional oversight was not only that the System was free to choose its own guides for policy, but that it was able to make political responses of its own choosing.

The target variable which the System consistently used as a guide for policy throughout the 1920's was the level of interest rates. The overall objective of System policy was to maintain sound financial conditions. To most Reserve officials, stable rates were both an indicator and a guarantee of sound conditions. Within this context, the condition of member banks was another indicator and, despite an abnormally high percentage of failures among small banks in agricultural regions, member bank ratios of net profits to capital accounts were maintained at relatively high levels throughout the decade. The effect of this policy, with a policy target so closely related to bank earnings, was to tie the System more closely to the banking community. In this sense, the System may be said to have chosen its own constituency, although provision for the election of a majority of the directors of the Reserve banks by the member banks may have made the choice inevitable. Commenting on this relationship, Professor Milton Friedman has said:

I think it has been an unfortunate thing that we have had a Reserve bank which has been as closely linked to the banking community and to the lending and investment process as it has, not at all because the individuals are trying to feather their own nests, not for that reason, but because they naturally interpreted the instrument they were dealing with in terms of the environment they knew best and were most familiar with.<sup>1</sup>

A second consideration which influenced the determination of rate levels was the System's commitment to reinstating an international monetary standard. In his analysis of Governor Strong's involvement with foreign central banks, Lester V. Chandler has ably refuted the charge that Strong acted without the knowledge or approval of the Federal Reserve Board and the administration. The international stabilization policies devised by Strong and Governor Montagu Norman of the Bank of England called for agreements between central banks as opposed to Governments because, as they saw it, the first step toward stabilizing European currencies was to rid central banks of the burden of underwriting Government debt. This did not mean, however, that these programs were undertaken outside a governmental context. The "altruistic" nature of the policy is reflected in Governor Norman's efforts to allay any suspicion of promoting English financial interests

<sup>1</sup> *The Federal Reserve System After Fifty Years*, Hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Cong., 2nd Sess., February-March, 1964, Vol. 2, p. 1165.

by using a committee of the League of Nations to implement his stabilization plans for several countries.<sup>2</sup>

A majority of Reserve officials actively favored some program for international monetary stabilization and it was noted within the System that these objectives could best have been accomplished through United States participation in the League. When in 1921 Governor Strong first proposed that the System participate with other central banks in an exchange stabilization fund, the Reserve bank governors gave him a vote of confidence which was not subsequently rescinded. The Board in effect sanctioned the efforts of the New York Bank in 1923, reprimanding the Boston Bank for refusing to participate in accounts for foreign central banks held on a System-wide basis and expressing the view that "the policy of establishing relations with foreign central banks . . . (is) desirable and in the public interest."<sup>3</sup> Meanwhile, the Government's position on the problem of war debts indicates a similar concern for international financial cooperation. Whether or not the commitment to an altruistic international program was sufficiently strong to have motivated the easy money policies of 1924 and 1927 as Wicker contends, or were merely an additional argument for policies conceived in terms of domestic needs as Friedman and Schwartz have argued, it could not have been implemented in an atmosphere devoid of political responsibility.

On the domestic front, the administration maintained the appearance of benevolent disinterest in the direction of monetary policy. Secretary of the Treasury Mellon was, however, no less responsive to the needs of the financial community than any other Federal Reserve official, and may have been more so. At the beginning of his tenure as Secretary, he used the office to rectify what he felt to be an unwarranted intrusion by the System into the affairs of the private banks. He took the position—as did most bankers—that open market operations by the Reserve banks constituted a form of competition with their member banks because of the effect on rate levels. Therefore, as was earlier discussed, he had insisted on the formation of a central committee to handle these transactions for the Reserve banks and, between May, 1922, and May, 1923, had forced the Committee to divest itself of over \$500 million of Government securities. Rates had risen substantially as a result of this action and the Secretary's policy during the remainder of 1923 was directed toward maintaining the higher levels and preventing any further purchases of securities by the individual Reserve banks.

<sup>2</sup> Lester V. Chandler, *Benjamin Strong, Central Banker*, Washington, D.C., The Brookings Institution, 1958, pp. 379-380, 389.

<sup>3</sup> *Stenographic Record*, October, 1921 Conference, pp. 721-741. Letter from W. P. G. Harding, governor of the Federal Reserve Bank of Boston, to J. H. Case, Deputy Governor of the Federal Reserve Bank of New York, June 14, 1923. Letter from Case to Harding, June 15, 1923. Letter from D. R. Crissinger, governor of the Federal Reserve Board, to Case, June 16, 1923 (FRB File 333.b.).

As the following excerpt indicates, the views of all interested parties were solicited in formulating an official position on the subject of relations with foreign central banks: "In response to a request for an expression of the views of the Board as to the desirability of continuing the policy of establishing relations with foreign central banks, Governor Crissinger stated that it was the view of the Board that these relations were desirable and in the public interest. Ten of the Federal Reserve banks having expressed the view that these arrangements were desirable, the Chairman was requested to have the Federal Reserve Bank of New York send each month to all participating banks a complete schedule of investments held for the account of foreign correspondents." (*Summary, Meeting of the Open Market Investment Committee, June 26, 1923, FRB File 333.b.*)

The Reserve bank governors had opposed the enforced sale of securities but were unwilling to engage in a confrontation with Secretary Mellon and the Board. With some bitterness, they absorbed their losses on sales—as did the public at large—as the price of Governments dropped, and watched their earnings dwindle from the loss of assets. Some saw the recession which began in the fall of 1923 as a direct result of this policy. With their backing, Governor Strong was able to moderate Mellon's position and respond to the recession in the summer of 1924. By the fall of that year it was agreed that open market operations should be used to keep financial conditions on an "even keel" and to stabilize rate levels.

For a few years, the choice of rate levels as a target variable solved the problem of housing two opposing monetary theories within one System. Those who favored a real bills approach—the large majority—sacrificed some purity of means for the sake of a congenial end result. Meanwhile, the small group of countercyclical enthusiasts accepted a financial framework for policy because for a while they were able to maintain a given level of prices by controlling the level of interest rates. There was, however, considerable disunity within the System in the wake of a shift in the locus of control. Before the formation of the first formal open market committee—an informal committee of governors having been in existence since 1915—there had been more or less a balance of power between the Governors' Conference and the Federal Reserve Board.

The formation of the Open Market Investment Committee in 1923 created problems for both groups. While it was nominally subordinate to the Board, the Committee rapidly assumed the prerogative of formulating policy as well as implementing it, leaving the Board with a somewhat limited power of approval. Meanwhile the New York Bank dominated the Committee to such an extent that the other Reserve banks felt their needs and wishes were ignored. In November, 1924, three of the five members of the Committee—the governors of the Boston, Philadelphia and Chicago Banks—voted for a proposal which would have undermined the Committee's authority by permitting the individual Reserve banks to make autonomous purchases. Although the proposal was lost on a 6 to 6 vote at the Governors' Conference, the Boston Bank subsequently defied the Committee by buying securities for earnings.

### *2. The struggle for control of policy within the System*

Secretary Mellon played a significant role in this three-way struggle for power between the Board, the Governors' Conference and the Open Market Investment Committee. (There was also, as has been noted, a struggle for power within the Committee between the New York Bank and the other Reserve banks.) Although he was an ex officio member of the Federal Reserve Board, Secretary Mellon appears to have found the attitudes and views of the Federal Advisory Council more congenial and used the Council to dominate the Board. The function of the Council was, and is, purely advisory. It represents the member banks in making policy recommendations to the Board but has no vote in System affairs. It was originally devised as a compromise arrangement to appease those who had felt that there should be representatives of the member banks on the Board itself. Since many

Reserve officials had been commercial bankers before joining the System, tended to favor some form of representation for the member banks, and were suspicious of a purely "political" Board, the Council had a good deal of influence.

Its influence was further enhanced by the eminence of many of its members. The first president of the Council was James B. Forgan, president of the First National Bank of Chicago, and a former president of the American Bankers Association. The New York district was represented during the early years by J. P. Morgan, and subsequently by Paul M. Warburg who served as president of the Council during the 1920's. Warburg had been vice governor of the Board from 1916 to 1918 but apparently was far happier in the dual capacity of private financier and policy advisor.

Warburg's position was what many Reserve officials would have preferred. He, with Forgan, Morgan, Benjamin Strong and others had been closely associated with the 1912 Aldrich central bank proposal and had never wholly relinquished its structure as a model. The ideal System from their point of view would have been more akin to a private corporation with a board of directors composed of eminent bankers and financiers, like the members of the Council, and a highly competent manager like Benjamin Strong. During hearings on the 1922 amendment to add a representative of agricultural interests to the Board—an amendment which the administration opposed—Secretary Mellon indicated that he, too, favored that sort of structure for the System. He thought that "one man" might be able to "administer all the business of those banks better than any board."<sup>4</sup>

In 1923, Secretary Mellon arranged for a representative of the Treasury to sit in on meetings of the Federal Advisory Council and by 1924, Under Secretary Garrard B. Winston was a regular participant in its deliberations. Correspondence between Winston and Warburg reveals that Mellon used the Council as an ally when his views were opposed by a majority of the Board. This arrangement raised the status of the Council and tended to give a larger voice in System affairs to officials more closely allied with private interests. Nevertheless, Secretary Mellon was extraordinarily sensitive to the appearance of Treasury intervention in Federal Reserve policy. The Minutes of Governors' Conferences during this period attest to his reluctance to have his statements and comments on record.<sup>5</sup>

The major issue over which the appointed members of the Board fought a losing battle with the Council and the Open Market Committee concerned the legality of repurchase agreements. The New York Bank began making these agreements in 1919 as part of its efforts to support a developing market for bankers' acceptances. Little notice was taken of the practice until open market operations became an important tool of policy and the Board realized the extent to which its own prerogatives in formulating policy had been assumed by the

<sup>4</sup> *Amendment to Federal Reserve Act*, Hearings before the House Committee on Banking and Currency, 67th Cong., 2nd Sess., March 15, 1922, p. 8.

<sup>5</sup> See Appendix B.

The status of the Federal Advisory Council is reflected in newspaper clippings of the period preserved in Secretary Mellon's files in the National Archives. Reporting a meeting of the Council, the May 13, 1924 issue of *The New York Journal of Commerce* announced: "Advisory Council to Decide Rate Policy." The February 23, 1927 issue of the same paper carried an article which reported that some businessmen wondered if the Council were doing all that it should "in the directing of our banking system."

Committee. In 1925, Adolph Miller—who, in 1923, had successfully pushed through the regulation requiring Board approval of the volume of purchases and sales by the Committee—took up the matter in conjunction with his campaign to require Board approval of the minimum buying rate for bills. Secretary Mellon opposed Miller's position, which had the support of Board members Cunningham and James, and got the Federal Advisory Council to bring pressure on the Board to drop both issues.<sup>6</sup>

By 1926, however, a majority of the Board had become concerned about the "pretty free access of the dealers into the Federal Reserve Bank with bills." A report prepared by Mr. Kenzel of the New York Bank, the manager of the open market account, stated that a large percentage of the total volume of purchases were bought directly from dealers or under repurchase agreements. Reading the report, the governor of the Board, D. R. Crissinger, drafted a memorandum in which he said that he wanted "the Board to understand the information is surprising to me because I think Governor Strong stated that they rarely bought from dealers, but occasionally did." Governor Crissinger concluded:

... you cannot always depend upon just what is said at an open market conference ... the only reliable information in these Banks must come from the operator.<sup>7</sup>

A majority of the Board agreed with Crissinger and voted to take a significant step toward bringing open market operations under closer surveillance. It was agreed that meetings of the Committee should be held in Washington and that the Committee should be required to meet with the Board. Governor Crissinger notified Governor Strong of the Board's action in the following terms:

It seems that the Board is under the impression that important argument and much information is brought out at these meetings which they are in a sense

<sup>6</sup> Correspondence between Garrard B. Winston and Paul M. Warburg, September 14 and September 15, 1923; February 11, February 12 and February 13, 1924; Mellon files, National Archives.

This correspondence establishes the fact that there was no precedent for relations between the Council and the Treasury and that, prior to 1924, no representative of the Treasury had been present at Council meetings. The degree of interrelationship and the extent to which it undermined the influence of the Board, is revealed in the February 1924, correspondence. Under Secretary Winston had written that he would be unable to attend the February 16 meeting of the Council. Warburg replied (February 11): "There are a number of very knotty problems on the Council's agenda, which indicate to me quite clearly that it would be most desirable to have you there, and on some of it we may greatly desire the Secretary's (Mellon's) aid. It is quite a blow that you won't be there to counsel with." Winston wrote back, requesting the agenda "so that I could post the Secretary on it" but advised Warburg in advance of the issue which particularly concerned the Treasury (February 12):

"There has been a question raised recently in the Federal Reserve Board which considerably disturbs me. You will recall that something over a year ago, although no formal request was made, the counsel for the Board gave an opinion that the repurchase agreements used by the Banks were illegal. Cunningham and James (Board Members) have recently taken the position that these agreements should be stopped. Miller (Adolph Miller, a Board member) takes the position that there is no justification for a rate for repurchase agreements differing from the discount rate. I think this is a subject which ought not to come up for discussion nor decision. Repurchase agreements seems to me a quite desirable means of maintaining a proper bill market in New York and are not prohibited by the Federal Reserve Act. I have talked this over with the Governor (Crissinger), and, if possible, the matter will be allowed to remain in status quo."

Warburg agreed (February 13):

"These open market rates must be dealt with with a good deal of discretion and elasticity," and, commenting on Miller's position—Miller thought changes in minimum buying rates should be approved by the Board and announced in the same way discount rate changes were announced—Warburg added that "if in each case the man in charge would have to go through the red tape of securing the Board's approval to the change and an official announcement, it would be fatal."

<sup>7</sup> Memorandum from E. R. Kenzel to the Open Market Investment Committee, "Practice of the Federal Reserve Bank of New York in the Purchase of Bills in the Open Market," January 21, 1926. Memorandum from Governor D. R. Crissinger to Board Secretary Eddy, January 31, 1926. FRB File 333.b.

deprived of even though the action of the Committee is reported to the Board, as has always been done.<sup>8</sup>

At its meeting of March 20, 1926, the Open Market Investment Committee categorically rejected the Board's decision. No longer the pawn of the Governors' Conference, the Board or the Treasury, it was nevertheless careful in communicating its decision to emphasize an awareness of its subordinate position. With the support of the Federal Advisory Council, it was able to overcome the Board's objections and prevent what it had termed "an inadvisable restriction upon the freedom of the committee."<sup>9</sup> It continued to meet in New York and retained its independence until the latter part of 1928.

Meanwhile, the individual Reserve banks had also watched the advancement of the Committee with reservations. While they had chafed at the Board's power and tended to gravitate toward the views of the banking community, there was a strong regionalist bias among their boards and staffs, independent of the issue of public versus private influence or policy orientation. The smaller Reserve banks resented the delegation of powers which affected their own individual operations to a committee composed of the larger Reserve banks. On the other hand, several of the larger Reserve banks objected to the fact that Committee policy did not always represent the views of the majority. The Boston, Philadelphia and Chicago Banks favored making individual purchases to meet expenses. To overrule the position, the New York Bank had to appeal to the Board for support. As a result, considerable antagonism had developed between the Reserve bank governors and the Board which worked to the Committee's advantage.

For several years the position of the Reserve banks and the Board on open market operations remained irreconcilable. The banks wanted the freedom to make individual purchases and the Board opposed individual purchases. By 1928, however, this issue had been resolved as the earning position of the Reserve banks improved. The issue then focused on control of policy. As the Chicago rate controversy of 1927 indicated, certain Board members and Reserve bank governors had recognized a community of interest in their relations with the Open Market Investment Committee. Although the Committee used the Board in that instance to force the Chicago Bank into line, the fact that Chicago was a member of the Committee clarified the issue for many and focused the attention of both groups on the fact that the Committee had served as a vehicle for the New York Bank's efforts to gain control of the system.

The Reserve bank governors favored a return to the old cooperative system in which the Governors' Conference had had a voice in policy equal to that of the Board. To the Board, too, it seemed that the old arrangement was more acceptable. In the latter part of 1928 a basis of agreement was reached between the two factions. The date is significant in that, with Governor Strong's death in October of that year, the New York Bank was unable to retain control of the Committee. In March, 1930, the Open Market Investment Committee was dissolved and replaced by the Open Market Policy Conference. The Conference, as its name implies, was an extension of the old Governors' Confer-

<sup>8</sup> Letter from Governor Crissinger to Governor Strong, March 30, 1926. FRB File 333.b.

<sup>9</sup> Minutes of the Open Market Investment Committee, March 20, 1926. FRB File 333.b.2.

ence in that all 12 Reserve bank governors were now members. The Board's former prerogatives were also reinstated. Its governor was made chairman of the Conference and empowered to call meetings, and the new regulations specified that the Conference would meet in Washington with the Board.

The effect of the reorganization of the open market committee was to decentralize the System and minimize the influence of the New York Bank. Unfortunately, another effect was to lengthen the odds against open market operations being used as an instrument of countercyclical policy during the early years of the depression. The only Reserve officials who favored such a policy were Governor George Harrison of the New York Bank, Adolph Miller of the Board and—after his appointment in February, 1932—Secretary of the Treasury Ogden Mills. While these three often acted as spokesmen for the System, they were unable to exercise leadership. They dominated the 1931 Senate hearings on the Crash, creating the impression that the System could and would react positively to the crisis. However, the depression deepened and, as President Hoover concluded, the System proved to be a "weak reed for a nation to lean on in time of trouble."<sup>10</sup>

The former president was more outspoken in his assessment of the origins of the depression. In his *Memoirs*, he wrote:

. . . I do not attribute the whole of the stock boom to mismanagement of the Federal Reserve System. But the policies adopted by that System must assume the greater responsibility.

The fact that action of such gigantic moment may be set on foot in a democracy, without adequate public consideration or check, emphasizes the dangers of undue powers in the hands of mere individuals, governmental or private.<sup>11</sup>

To support his contention, Mr. Hoover quoted from a summary of the views of Adolph Miller which appeared in the magazine *Sphere* in July, 1935:

Mr. Miller, of the Federal Reserve Board, states that the easy credit policy of 1927, which was father and mother to the subsequent 1929 collapse, was originated by Governor Strong, of the New York Federal Reserve Bank, and that it did not represent a policy either developed or imposed by the Board on the Reserve Banks against their will.

The policy was the result of a visit to this country of the Governors of foreign central banks who unequivocally stated in New York that unless the United States did adopt it there would be an economic collapse in Europe. It was a European policy, adopted by the United States.<sup>12</sup>

Thus, Mr. Hoover places the blame for soaring stock market prices, the ensuing crash and the depression firmly at the feet of the Federal Reserve System. One need not agree with these remarks to give the position weight in appraising the relationship between the Federal government and the monetary structure. Few would challenge the view that an ill-advised monetary policy could precipitate and perpetuate such an economic disaster, even those who question its value as a remedy for such an event. That Mr. Hoover would accuse Reserve officials of misconduct of such far-reaching consequence is not without significance. The accusations of Mr. Miller only compound the problem of determining responsibility. More significant is the fact that an American president had called into question the scope and purpose of the monetary instrument itself.

<sup>10</sup> Herbert Hoover, *The Great Depression, 1929-1941, The Memoirs of Herbert Hoover*, New York, The MacMillan Co., 1952, p. 212.

<sup>11</sup> *Ibid.*, p. 13.

<sup>12</sup> *Ibid.*, footnote 8, p. 13.

## CHAPTER XII

### THE BANKING ACT OF 1935

Between January and March, 1933, the System began to "drift," as Adolph Miller put it. With conditions worsening, the Board postponed decisions and rejected even the most conservative suggestions, such as the proposal for issuing clearing house certificates which President Hoover and Miller favored. Miller commented to a colleague, C. S. Hamlin, that "this inertia made him feel that the whole Board should be reorganized."<sup>1</sup> Shortly thereafter, a major piece of banking legislation came before Congress, but the emphasis was on provisions for deposit insurance. An effort was made to strengthen the Board's supervisory powers to control the use of Reserve bank credit for speculative purposes and in foreign transactions, but there was no attempt to reorganize the System. The Banking Act of 1933 merely sanctioned changes which had already occurred, for the first time giving legal recognition to the existence of an open market committee.

In March, 1933, the Nation watched with more than usual interest the change in personnel after 12 years of administration by one party. There were no changes in the Federal Reserve System because of its insulation from political influence, and the majority of its personnel had joined the System in the Wilson and Harding eras. The new political environment may have had some impact on the System, however. It may have precipitated the resignation of Eugene Meyer, the Governor of the Board who, C. S. Hamlin reports, saw Roosevelt's election as unlikely "to inspire confidence in the country."<sup>2</sup> Meyer's replacement was the governor of the Federal Reserve Bank of Atlanta, Eugene R. Black. Slightly more than a year later Black returned to his former post and in November, 1934, President Roosevelt appointed Marriner S. Eccles, a Utah banker serving in the Treasury, to head the System.

#### 1. *Chairman Eccles' proposals.*

In Eccles' opinion, the problem with the Federal Reserve System was that it was largely controlled by private banking interests. He was convinced that a complete legislative overhaul was necessary to rid the System of these influences and make it effective. The responsibility for drafting legislation had been delegated, however, to a committee on which the Board was represented by only one member—"all others," he writes in his autobiography, "represented the private-banking viewpoint." This was only one area in which the original powers of the Board had been eroded, but it represents the kind of distortion which occurred in the absence of governmental supervision.

<sup>1</sup>The Diaries of C. S. Hamlin, quoted by Elmus R. Wicker, *Federal Reserve Monetary Policy, 1917-1933*, New York, Random House, 1966, p. 191.

<sup>2</sup>*Ibid.*, p. 185.

Eccles brought the matter before the Board and his proposal to abolish the committee and recapture its powers was sustained.<sup>3</sup>

The reform measure drafted by Governor Eccles and members of the Board's staff consisted of three separate titles. Title I modified and made permanent the provisions for Federal deposit insurance enacted in 1933; Title II amended the Federal Reserve Act; and Title III consisted of technical amendments to the National Currency Act, the Federal Reserve Act, the Banking Act of 1933, and related statutes. With certain exceptions, the provisions of Title I and Title III were noncontroversial and were favored by the banking community. Opposition to Title II was anticipated and it was hoped that combining the three Titles would facilitate passage.

The provisions of Title II are significant in the context of this narrative because they were an attempt to order and make rational the experience of the two preceding decades. As reported by the House Committee on Banking and Currency, the bill contained provisions designed to accomplish the following objectives:

1. To increase the ability of the banking system to promote stability of employment and business, insofar as this is possible within the scope of monetary action and credit administration.
2. To concentrate the authority and responsibility for the formulation of national monetary policy in a body representing the general public interest.
3. To modify the structure of the Federal Reserve System to the extent necessary for the accomplishment of these purposes, but without interfering with regional autonomy in matters of local concern.
4. To relieve the banks of the country of unnecessary and hampering restrictions, and thus enable them to meet the credit needs of their communities more adequately and contribute more effectively to the acceleration of recovery.<sup>4</sup>

As the fourth of these excerpts implies, Title II of the House bill sought to revise, clarify and coordinate the emergency provisions which, enacted in 1932 and 1933, relaxed various restrictions in the Act to make credit more readily available and increase the money supply. The changes proposed in the provisions for discount operations, member bank borrowing and real estate loans removed various restrictions in existing law and provided that "soundness" of assets be used as the criteria in extending credit. The latter was intended to liberalize the ground rules for issuing Federal Reserve notes and crediting member bank reserve balances. Further, the House bill provided generally for greater flexibility in administering Federal Reserve credit facilities, and emphasized the Board's authority and responsibility in supervising the lending activities of the Reserve banks.

The House amendment to section 16 proposed to remove the restrictions on note issue, again in an effort to simplify and coordinate various emergency provisions previously enacted. Among these emergency currency measures was the Glass-Steagall Act of 1932 which permitted Government securities to be pledged as collateral security for Federal Reserve notes until March, 1935 with provision for a 2-year extension; and the Emergency Banking Act of 1933 which repealed the redemption clause—making Federal Reserve notes, in effect, legal tender—and which provided for the issuance of Federal Reserve bank notes without gold backing. These measures—or, rather, the

<sup>3</sup> Marriner S. Eccles, *Beckoning Frontiers*, New York, Alfred A. Knopf, 1951, p. 191.

<sup>4</sup> House Report No. 742 to accompany H.R. 7617, 74th Cong., 1st Sess., April 19, 1935, p. 1.

need for them—had demonstrated that collateral requirements were too restrictive. Therefore, the House amendment repealed collateral requirements for Federal Reserve notes and provided that currency subsequently issued be an obligation of the United States, a first and paramount lien on the assets of the issuing Federal Reserve bank, be backed by a 40 percent gold reserve, and be legal tender. The House amendment further repealed the prohibition against one Federal Reserve bank paying out the notes of another.

Testifying on these sections of the bill, Governor Eccles explained:

. . . in an effort and under pressure to get liquidity, they (the banks) froze themselves so completely that they finally closed the entire banking structure. So it was found out that, in the final analysis, in a depression, there is no liquidity, except that liquidity which can be created by the Federal Reserve or the central bank through its power of issue.

\* \* \* \* \*  
 We finally recognized that we did not have to have eligible paper and we did not have to back our currency with gold or eligible paper or even with Government bonds. We finally recognized that, in order to get the banks open, we could take any sound asset into the Reserve bank and issue Federal Reserve bank notes. When that happened nobody wanted their money, the runs stopped, and liquidation stopped to a very great extent.<sup>5</sup>

Ignoring the contention of the bill's sponsors that these relaxations had proved necessary to stimulate recovery in the private sector of the economy, those who opposed the bill argued that in conjunction with the authority for direct purchases of Government bonds by the Reserve banks, these provisions were extremely inflationary and were designed to help finance Government spending programs by forcing the System to "load up" on Governments at the expense of commercial paper.

These sections of the bill were substantially eliminated by Democrats in the Senate on the grounds that the existing emergency measures had met the crisis and could be used further, if necessary, to aid recovery, while nothing in the current situation appeared to justify such radical changes in the law. In conference, the Senate amendments were insisted upon and the final version of the Act perpetuated the status quo, both retaining existing restrictions in the Act, and reenacting the temporary relaxations of the law.

While debate on the above issues had been extensive, one of the more controversial provisions of Title II proposed to combine the offices of Reserve Bank governor with that of chairman of the board and Federal Reserve agent. The new officer, entitled governor, would be selected by the board of directors annually with the approval of the Federal Reserve Board initially and again after three years. The governor would not, therefore, be directly responsible to the central Board, as had been the Federal Reserve agent, but, with the provision that he become a Class C director on election and act as chairman of the Reserve bank board, his obligation to function as a public official would be firmly established.

Republican Members of the House Banking and Currency Committee objected:

At the present time the Governor of each Federal Reserve bank, its chief executive officer, is selected annually by the directors of the bank. He is responsible to his board, and not to the Federal Reserve Board. Under this bill he must be

<sup>5</sup> Statement of Marriner S. Eccles, Governor of the Federal Reserve Board, March 5, 1935; *Banking Act of 1935*, Hearings before the House Committee on Banking and Currency on H.R. 5357, 74th Cong., 1st Sess., p. 194.

subject to the approval of the Federal Reserve Board when first designated as Governor, and each three years thereafter, if redesignated, he must again be subject to the Board's approval, thus removing to a great extent the independence which he has enjoyed in the past.<sup>6</sup>

While the specific duties and functions assigned the chairman of the board and Federal Reserve agent under the original Act only implied designation as chief executive officer, the weakness of the Republican argument was the assumption that an officer could be presumed invested with the "chief executive" function outside the law. The arguments of both sides were expressed in the following colloquy:

Mr. Patman: Is it not a fact that there never was any legal authority for the office of governor of a Federal Reserve bank?

Mr. Hollister: "What the gentleman means by that is not that it is an illegal office."

Mr. Patman: "I am speaking of realities. Is it not a fact that the provision in the pending bill changing the title of Federal Reserve agent to governor is abolishing an office that does not legally exist?"

Mr. Hollister: "Absolutely not. The office of governor as it now exists is in no sense illegal."

Mr. Patman: "Congress cannot abolish something Congress has not created."

Mr. Hollister: "Yes, it can; Congress can abolish things it has not created; and that is exactly what is done by this provision of the pending bill—it abolishes the right of the directors of a Federal Reserve bank to appoint their own chief executive officer."<sup>7</sup>

The Senate amendment, creating the office of Federal Reserve Bank President, conformed substantially to the existing arrangement for selecting bank governors except that provisions were made for approval by the Federal Reserve Board on a 5-year basis. A notable omission was that provision of the House bill which provided that the Governor would become a Class C director. The Senate amendment retained the original provisions relative to the structure of the bank board of directors and the office of chairman of the board, Federal Reserve agent, and representative of the Federal Reserve Board, but in effect placed this officer in a subordinate position. Those changes—which were adopted by the conferees—implied greater independence from the Board and ignored the principle, which the House bill sought to clarify, that the chief executive officer of a Federal Reserve bank should be a public official functioning in the public interest.

## 2. *Debate over control of open market operations*

The most significant changes proposed in the bill which passed the House in 1935 involved provisions which would have substantially altered the structure of the System by enlarging the powers of the Federal Reserve Board. The bill expanded the supervisory and regulatory role of the Federal Reserve Board in the areas of discount oper-

<sup>6</sup> Minority Views of the Committee on Banking and Currency, to accompany H. Rept. No. 742 on H.R. 7617, 74th Cong., 1st Sess., April 19, 1935, p. 33.

<sup>7</sup> *Congressional Record*, 74th Cong., 1st Sess., Vol. 79 (1935), p. 6726.

Senator Glass' position in 1932 had been very close to that of proponents of the 1935 House bill. He had argued at that time:

"There is not a word in the law which provides for a 'governor' of a Federal reserve bank. The statute will be searched in vain for any suggestion of a 'governor' of a Federal reserve bank.

"While we intended to preclude all idea of central banking, we designed that the Government, through its agencies, should keep a strict supervisory control of the system, and we appointed a Government agent, one of three of the Government directors at the Federal reserve bank, who should be the presiding officer, and whom we intended to be the head officer of the bank. He has been literally brushed aside. He is a mere custodian of evidences of credit. They have set up in each of these banks a government of their own" (*Congressional Record*, 72d Cong., 1st Sess., Vol. 75 (1932), pp. 9884-9885).

ations, note issue, and real estate loans by member banks; placed specific emphasis on the policy-making function of the Board; empowered the Board to initiate changes in discount rates; modified the Thomas amendment of 1933 to permit the Board to decrease or increase reserve requirements without Presidential approval or the declaration of an emergency; and transferred authority to conduct open market operations from a committee composed of representatives of the Reserve banks to the Federal Reserve Board.

"In view of the added powers proposed to be conferred on the Federal Reserve Board," the House report stated:

. . . and to insure that these powers will be exercised in the public interest, it is desirable for Congress to lay down as definite instructions as are practicable. The present objective, the accommodation of commerce, industry, and agriculture, is inadequate as an expression of the will of Congress. It is felt that what the people really expect of monetary management is that it should be directed toward promoting business stability.

Accordingly, a new paragraph was added to section 11 of the Federal Reserve Act, requiring the Board:

. . . to exercise such powers as it possesses in such manner as to promote conditions conducive to business stability and to mitigate by its influence unbalancing fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration.

The addition of this policy directive, the Committee noted:

. . . would furnish a criterion by which the public and its Representatives in Congress could assess the merits of monetary policy. It would provide an added assurance that monetary control would be exercised in the interest of the Nation as a whole.<sup>8</sup>

The House Committee argued that these objectives would not be obtained unless authority to conduct open market operations were transferred from the Federal Reserve banks to the Federal Reserve Board. Describing the drawbacks under current law, the Report stated:

We have, therefore, an arrangement by which there is a policy-making body of 12, which has power to formulate policies, but not to put them into effect. We have the Federal Reserve Board, consisting of 8 members, who have the authority to approve or disapprove of the recommendations of the committee; and we have 108 directors of the Reserve banks, who have final determination as to whether the policy is to be carried out or not. It would be difficult to conceive of an arrangement better calculated than this for diffusing responsibility and creating an elaborate system of obstructions.<sup>9</sup>

The 1935 amendment would "cure this situation," the Committee argued,

. . . by placing responsibility for national monetary and credit policies squarely upon the Federal Reserve Board. It will eliminate conflicts of jurisdiction and policy because the final decision as to all matters affecting national policies would be vested in the Federal Reserve Board . . . a national body, as they properly should be in the public interest.<sup>10</sup>

Sponsors of the bill emphasized that the proposed changes in the open market provisions represented a reassertion of the principle of public control intended by President Wilson and proponents of the original legislation. Under the 1913 Act, the Federal Reserve Board

<sup>8</sup> H. Rept. No. 742, to accompany H.R. 7617, 74th Cong., 1st Sess., p. 9.

<sup>9</sup> *Ibid.*, p. 10.

<sup>10</sup> *Ibid.*, p. 10.

had been given final authority over changes in discount rates, authority to compel one Federal Reserve bank to discount the paper of another, authority to transfer reserves and to suspend, under certain limitations, reserve requirements for member banks—powers of coordination to insure that the Federal Reserve banks would “. . . pursue a banking policy which shall be uniform and harmonious for the country as a whole.”<sup>11</sup>

Quoting the above excerpt from the Report on the 1913 bill, the 1935 House Report noted :

It is for this reason that the original Federal Reserve Act gave the Federal Reserve Board final authority over discount rates. Since open-market operations have in more recent years come to be recognized as a much greater factor in credit policy than discount rates, it is entirely consistent with the philosophy of the original Federal Reserve Act to vest in the Federal Reserve Board final authority with respect to the open-market policies of the Federal Reserve System.<sup>12</sup>

But as this transfer of authority indicates, the 1935 House bill proposed not only to retrieve the position of the Board within the System, but to retrieve open market operations from the restrictions imposed by the 1933 Act. The Board's original authority could have been reasserted as well by an out-right prohibition against coordination of purchases and sales, but this possibility was rejected, and the alternative—centralization—chosen in recognition of the effects of these transactions. As Governor Eccles explained, “In our present money System, I know of no other means within the banking system itself of influencing or effecting control over the supply of money.” Therefore, he proposed that open market operations be used :

. . . to combat deflation, which means unemployment, and unemployment means reduction in national income, in wealth production, and wealth consumption.

That is where the problem must be met, and it must be met, it seems to me, by society as a whole, through Government.<sup>13</sup>

Similarly, Congressman Hancock of North Carolina argued that, inasmuch as open market transactions “affect the purchasing power of the people,” it constitutes “. . . the most important function of government and it is the exercise of the sovereign power of a central government.” Further—reviving the Constitutional argument on which, in 1913, the Democratic Party had based its insistence that considerable powers of control be vested in a purely Governmental board—Mr. Hancock asserted that the proposed transfer and centralization of this authority, coupled with the Congressional mandate to direct its use, would effect “. . . a recapture on the part of the Congress of its powers to coin money and regulate the value thereof.”<sup>14</sup>

In a Minority Report on the bill, Republican Members of the House Committee chose to ignore arguments by Members of their Party in

<sup>11</sup> H. Rept. No. 69, to accompany H.R. 7837, 63rd Cong., 1st Sess., September 9, 1913, p. 16.

<sup>12</sup> H. Rept. No. 742, to accompany H.R. 7617, 74th Cong., 1st Sess., p. 10.

It should be noted that the 1935 debates focused not only on the issue of private versus public control, but also on that of central versus local control. The two issues were joined and complicated by the fact that many who argued against centralization would appear to have been covertly pleading for private, not local, control; while those who were most vehemently for public control had severe reservations about discarding the regional cast of the System as proposed in the House bill.

<sup>13</sup> Statement of Governor Marriner S. Eccles, March 19, 1935. *Banking Act of 1935*, Hearings before the House Committee on Banking and Currency on H.R. 5357, 74th Cong., 1st Sess., p. 402.

<sup>14</sup> *Congressional Record*, 74th Cong., 1st Sess., Vol. 79 (1935), p. 6733.

1913 to the effect that the powers of the Board were too great. They described the role of the Board under the original Act as that of "an independent supervisory body"; asserted that the Federal Reserve banks were "private institutions"; and argued that:

This separation of the Reserve banks from governmental control is in accordance with central banking practice in most of the more highly civilized countries under a democratic form of government. . . . Conversely, countries under close dictatorship, like Italy and Russia, have central banks entirely under Government domination. One of the first and essential steps in any dictatorship is to extend power over the credit resources of the country.<sup>15</sup>

But, while attempting to discredit the notion of public control, Republican Members did not object to centralization as such. Congressman Hollister of Ohio, ranking minority Member of the House Committee on Banking and Currency, stated the position during debate on the bill:

Mr. McCormack. . . . Does the gentleman believe there should be a more centralized power some place? . . .

Mr. Hollister. . . . I think, in certain aspects, there might be a more centralized control in the event that centralized control could be exercised by a body which was not in any way tied in with the administrative and executive policies of any particular administration or under any particular political control.

. . . I feel that with an absolutely independent central board it would be safe to grant additional powers; that with a board that is subject to outside control, as the present board is, the powers now given are as much as should be given and perhaps go a little further than should be granted.

Mr. Martin. It strikes my mind that in the mind of the gentleman and those who take his view of this legislation, his objection is rather to where the power is lodged under the bill rather than the increased power extended to the Federal Reserve System.

Mr. Hollister. That is chiefly it; although, as I said to one of the gentlemen, that is a question I would not want to settle finally at this time.<sup>16</sup>

In line with these last remarks, the House Minority Report argued for reinstatement of the 1933 open market provisions as preferable to centralization of this authority in the Federal Reserve Board. Nevertheless, as noted, the Minority did favor centralization of open market operations provided control of these transactions was not in the hands of the Government. The Senate amendment conformed substantially to these criteria.

Senator Glass, co-author of the 1913 and 1933 Acts and a formidable opponent of the 1935 proposal, objected that the House bill:

. . . proposed to make the open-market committee the supreme power in the determination of the credits of the country. No such thing was intended, and no such thing should ever be done.<sup>17</sup>

<sup>15</sup> Minority Views of the Committee on Banking and Currency, to accompany H. Rep. No. 742 on H.R. 7617, 74th Cong., 1st Sess., p. 32.

The views of the Minority Members of the House Committee on the 1913 bill were as follows:

"The powers of the Federal Reserve Board are, in our judgment, too great. This board should be given supervision, but not actual management of the banking business of the country" (Minority Views of the Committee on Banking and Currency to accompany H. Rep. No. 69 on H.R. 7837, 63rd Cong., 1st Sess., September 9, 1913, p. 133).

<sup>16</sup> *Congressional Record*, 74th Cong., 1st Sess., Vol. 79 (1935), pp. 6731-6732, 6733.

<sup>17</sup> *Ibid.*, p. 11778.

Senator Glass opposed the 1935 proposal on the grounds that:

"Here is a board originally established and now operating as the central supervising power. The Government of the United States has never contributed a dollar to one of the Reserve banks; yet it is proposed to have the Federal Reserve Board, having not a dollar of pecuniary interest in the Reserve funds or the deposits of the Federal Reserve banks or of the member banks, to constitute the open-market committee and to make such disposition of the reserve funds of the country, and in large measure the deposits of the member banks, as they may please, and without one whit of expert knowledge of the transactions which it was proposed to commit to them." (Remarks of Senator Glass, July 24, 1935; *Ibid.*, p. 11778.)

The position of the Senate Committee was outlined by Senator Glass in the following remarks on the Conference Report:

Some of us were opposed to any alteration of the existing arrangement. Others thought that the representatives of the banks, whose money is to be used, whose credit is to be put in jeopardy, should have control of the committee and should have the majority representation. But in order to reconcile bitter differences there was yielding, and we have now proposed an open-market committee composed of all 7 members of the Federal Reserve Board and 5 representatives of the regional reserve banks.<sup>18</sup>

### 3. *The adopted version*

The Senate amendments to the open market provisions were adopted by the conferees with two notable exceptions. In a recapitulation of the two versions, Congressman Goldsborough of Maryland explained the changes made at the insistence of the House conferees:

The conception of the Senate was that the operations of the open-market committee should be controlled by the banks. The theory of the House was that the operations of the open-market committee, involving as they do the placing of money in circulation and withdrawing it in order to prevent on the one hand inflation, and on the other deflation, was a public function and should be controlled entirely by representatives of the people.

In view of similar arguments by Republicans in the House, a number of Democrats favored Government ownership of the Federal Reserve banks and an amendment was offered by Rep. Cross authorizing the Secretary of the Treasury to purchase stock in the Federal Reserve banks from the member banks (*Ibid.*, p. 7251). Those in charge of the House bill evidently did not anticipate that arguments such as Senator Glass' would prevail in the Senate, and the pros and cons of Government ownership were debated in the following terms:

Mr. HANCOCK. "Does not the gentleman think it is much more important that the Government exercise control over the regional banks than it is that they shall own the stock in the banks; and does not the gentleman think that the emphasis should be placed upon the control rather than the ownership, especially where the ownership does not carry with it control?"

Mr. PATMAN. "I feel that in this case both ownership and control are necessary. This is a question of issuing and distributing currency. . . . The question is, are you going to let a corporation that is owned by private corporations continue to exercise this function, which the Constitution says Congress shall exercise? . . . Do you want them to continue to enjoy that privilege, or are you willing to take it away from them and put it back under the supervision and control of Congress, where the Constitution of the United States says it really belongs?" (*Ibid.*, p. 7254.)

This is unfortunately the only occasion in 1935 on which the principle of public control was tested in isolation from the bill as a whole and, in view of the objections of Committee Members, the amendment was defeated. An amendment to the amendment—offered by Rep. Patman and providing for the reinstatement of the franchise tax—was agreed to, giving some indication of the strength of the position, but was lost in the defeat of the Cross amendment. (*Ibid.*, pp. 7253-7255; 7260.)

<sup>18</sup> *Congressional Record*, 74th Cong., 1st Sess., Vol. 79 (1935), p. 11778.

Actually, as the Senate hearings reveal, this compromise plan was first recommended by Francis M. Law, president of the First National Bank of Houston, Texas and previous president of the American Bankers' Association, who appeared on behalf of the ABA's Banking Studies Committee, and by Winthrop W. Aldrich, Chairman of the Chase National Bank of the City of New York, a member of the same ABA legislative committee and chairman of the special committee of the Business Advisory Council for the Department of Commerce which had been appointed to study and make recommendations on the proposed measure. Both committees represented by Mr. Aldrich recommended that the Federal Reserve Board be reduced to 5 members (omitting the Secretary of the Treasury, the Comptroller of the Currency, and one appointed member); and that the Open Market Committee be reconstituted to consist of all 5 members of the reconstituted Board, plus 4 governors of the Federal Reserve banks:

"\* \* \* whose independence shall have been protected in the manner already recommended (i.e., that the governor be made subject to Federal Reserve Board approval only once, and that no reapproval be required), and who shall be freely elected to the committee by the governors of all Federal Reserve banks." (*Banking Act of 1935*, Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 1715 and H.R. 7617, April 19 to June 3, 1935; p. 409. See also pp. 368-373, 385, 395.)

Mr. Aldrich's arguments for the independence of Reserve bank governors and the Board were made in conjunction with the charge that the House bill proposed "political" control of the banking system. Pressed by Senator Couzens to define "political control," Mr. Aldrich was one of the few advocates of the position who attempted an explanation:

Mr. Aldrich: "What I intend to mean here is that to place the control of the currency and the credit of the country in the hands of individuals who are subject to removal by an administration, is to place the power in an administration to utilize the system for the purpose of creating a boom at the time when an election approaches." (*Ibid.*, p. 393.)

With that in view, the members of the Banking and Currency Committee of the House, and the House itself, adopted a provision that the open-market policy would be controlled exclusively by the members of the Federal Reserve Board. The Senate bill provided that the open-market policy should be controlled by the Federal Reserve Board and five representatives of the Federal Reserve banks.

It also provided that two members of the Federal Reserve Board should be experienced bankers; so that the Senate bill would have placed on the open-market committee 7 bankers and 5 non-bankers, which would have given control of the open-market policy to private banking interests.

The Senate bill also provided that of the 5 bankers 1 should have a roving commission or should be a member at large, the purpose of this being to give the New York district 2 representatives instead of 1.

The conference report says that the open-market committee shall consist of 7 members of the Federal Reserve Board and 5 members of the Federal Reserve banks, each one of whom shall represent a different Federal Reserve district and shall come from a different section of the country; and the conference report also provides that the two bankers who would be on the Federal Reserve Board shall not be required by law to be there. So that, as the chairman has said, while unfortunately the policy of the House has not been carried out in toto—in other words, the undiluted principle that the public money shall be used for the purpose of the exchange of goods and commodities is not in the conference report—the conference report in a practical way protects the public, because the 7 members of the Federal Reserve Board sit here in Washington and they are a cohesive body, while the 5 bankers are scattered all over the United States and do not constitute a majority of the open-market committee.<sup>19</sup>

As Mr. Goldsborough had noted, the Senate conferees recognized that the House would prefer to accept the Senate amendment than to have no bill at all, while as Senator Glass had made clear, a continuation of existing law was not uncongenial to the Senate conferees.<sup>20</sup> Therefore, as reported in the following colloquy, the Senate conferees argued for the principles expressed in the 1933 Act:

Mr. Goldsborough. I will say to the gentleman from Massachusetts (Mr. Gifford) that the strength and power of the Senate conferees said that the public has got no right to be represented on the open-market committee at all; they have no stake in it. The strength of the Senate conferees was that the control of money belongs to the bankers and not to the people, and that was stated in that conference a dozen times. We had to sit there and listen to that statement. The Federal Reserve Board has no stake in this thing. The open-market committee ought not to have any stake in it. They ought to operate it in the public interest and in the public interest alone.

Mr. Gifford. Then the gentleman would continue to say that the Senate preferred the bankers to handle the people's money from a matter of principle, and not from the present conditions?

Mr. Goldsborough. God only knows why anybody would want to say that the people's medium of exchange should be controlled by any private interests; but that is what they said at least a dozen times.

Mr. Steagall. Which they were not allowed to write into this bill?

Mr. Goldsborough. They were not allowed, as the chairman says, to write any such infamous principle into the bill.<sup>21</sup>

The conference report was adopted by both Houses on voice votes, but the votes of a majority of House Republicans would appear to have been assured by the indorsement given the conference report by Congressman Hollister. Noting that the House and Senate versions of the bill were "quite different," Mr. Hollister stated:

Notwithstanding my opposition to various parts of the House bill, this bill now has my unqualified support and I hope it will receive the support of Members on both sides of the Chamber.<sup>22</sup>

<sup>19</sup> *Congressional Record*, 74th Cong., 1st Sess., Vol. 79 (1935), p. 13709.

<sup>20</sup> *Ibid.*, pp. 11824-11825, 13710.

<sup>21</sup> *Ibid.*, p. 13711.

<sup>22</sup> *Ibid.*, p. 13706.

#### 4. Summary

The Banking Act of 1935 is generally accepted as a milestone in the evolution of the Federal Reserve System, and often viewed as the statutory recognition of an inevitable development away from the limited economic concepts embodied in the 1913 Act. As one economic historian writes, the commercial loan theory of currency, already eroded by the 1916 and 1932 amendments, was at last “decently interred.”<sup>23</sup> However, the 1935 amendments as enacted contain little hint of such a renunciation or interment. Currently, the American monetary system is composed of a series of procedures based on statutes and statutes based on procedures, which reflect no integral concept of money but, rather, a series of residual concepts. Since at no point is any concept of money firmly repudiated, the system may be said to accommodate a process of selection among alternatives. It preserves the procedural framework of an asset currency system but in reality is closer to fiat money.

One advantage of fiat money—the non-interest bearing feature—is conspicuously absent from the current system. Even so, the system cannot be said to embody any absolute principle as to payment of interest on the issuance of money in that—to the extent that money is issued through open market operations by the Reserve banks and interest paid the Reserve banks on bond holdings is returned to the Government in however large or small an amount—the procedure is less than uniform in effect and the principle partially mythological. Further, the procedure by which one Government obligation secures another in what seems a parody of asset currency is a curious *reductio ad absurdum* which would not appear to satisfy the conditions for “decent interment.” However, the more rational procedures proposed in the 1935 House bill were termed “fiat money” by the opposition, and the superfluity of irrelevant procedures retained in current law may reflect an attempt to mitigate outright acceptance of a system with pejorative connotations. Thus, the amendments to the House bill would appear to have confused the issue while acting to rectify the problem since, however incoherent the procedures, their ultimate effect was to make for a more cohesive and efficient system of issuing money and influencing credit.

Most importantly, the 1935 Banking Act fails to provide guidelines on monetary policy. No guidance is given on how to resolve any emerging conflicts among the goals of full employment, price level stability and balance of payments equilibrium. Nor is guidance given on operating strategy. Federal Reserve authorities remain free to try to achieve their goals of the moment by tactics deducible from the real bills doctrine or, alternatively, by a quantity theory of money strategy—that is, by zeroing-in on interest rates and free reserves on the one hand, or base or high-powered money and money supply on the other hand. All too frequently the real bills doctrine has dictated strategy and money supply thereby has been allowed to grow too slowly (or too rapidly) because the behavior of interest rates and free reserves wrongly indicated that policy was sufficiently easy (or tight). The result has been that the Federal Reserve continues to contribute to economic instability.

<sup>23</sup> Harold Barger, *The Management of Money*, Chicago, Rand McNally, 1964, p. 119.

Meanwhile, as the Federal Reserve System has evolved over the decades since 1935, conflicting views of its function would seem to have been perpetuated rather than resolved. To the banking community, the Federal Reserve System represents, alternately, an essentially cooperative enterprise or a Government regulatory agency on which it demands some representation to assure decisions sympathetic to its needs. To other observers, it represents an institution through which the assets, prestige, and sovereignty of the United States Government are placed at the disposal of the banking community for purposes of private investment.<sup>24</sup> Perhaps to individual members of the banking community, the System appears sufficiently oblivious to their requirements for growth and profit. To others, the too adequate representation of banker opinion in Federal Reserve deliberations guarantees that a most narrow view of public policy will prevail.<sup>25</sup>

The history of the Federal Reserve System reveals no greater frequency of malfeasance than in other sectors of Government, but does indicate that administrative response to private rather than public views is built into the System. For at the level of execution of policy, it should be noted that despite alterations in the System's structure over the past 6 decades, bankers still elect two-thirds of the directors of the Reserve banks who in turn appoint the Reserve bank presidents who manage these institutions and, more importantly, sit on the Federal Open Market Committee. Given the fact that a select group of individuals, representing a small portion of the population and perhaps a single economic point of view, has the prerogative of selecting these key officials, it would appear inevitable that these officials should represent the interests, or at least reflect the intellectual biases, of those who select them. If this is an illusory idea, then so, it would seem, is the concept of representative Government.

With respect to the argument that the Federal Reserve System acts as a necessary check or balance in a Government which originally envisioned only three such balancing powers, it should be noted that within the System itself there is considerable diffusion of authority. It is difficult to settle responsibility for a given action on any single individual or group among the various groups to whom the prerogatives of power have been given. Further, the secrecy of deliberations, long tenure of office and overlapping terms make it impossible to predict when a given point of view will be initiated or terminated. It has been suggested that the Federal Reserve System acts to thwart the will of representative Government. But, considering the extent of its influence on events and the cataclysmic nature of the events it survived, the truly astonishing aspect of its history has been its ability to evade responsibility. In a democratic society, as Professor Paul Samuelson observed: "A central bank that is not responsible is irresponsible, rather than independent. To be responsible means to be responsive."<sup>26</sup>

<sup>24</sup> The report of the Commission on Money and Credit states:

"... What was thought of in 1913 as essentially 'a cooperative enterprise among bankers for the purpose of increasing the security of banks and providing them with a reservoir of emergency resources' has not ceased to be that. But it has also become one of the most potent institutions involved in national economic policy" (*Money and Credit: Their Influence on Jobs, Prices and Growth*, Report of the Commission on Money and Credit, Englewood Cliffs, N.J., Prentice-Hall, Inc., 1961, p. 85).

<sup>25</sup> In fairness it should be noted that at the present time, of the six members of the Board, none were bankers prior to appointment, and of the twelve presidents of the Reserve Banks, only three were bankers.

<sup>26</sup> *The Federal Reserve System After Fifty Years*, Hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Cong., 2nd Sess., February-March, 1964, Vol. 2, p. 1105.

# APPENDIXES

## APPENDIX A

### THE 1922 SYMPOSIUM ON CREDIT POLICY

(1) LETTER FROM THE SECRETARY OF THE FEDERAL RESERVE BOARD TO THE GOVERNORS AND BOARD CHAIRMEN OF THE FEDERAL RESERVE BANKS

"X-3518—September 9, 1922.

"Subject: Discussion of Federal Reserve Credit Policy at the Joint Conference of Governors and Chairmen.

"DEAR SIR: It has been suggested to the Federal Reserve Board that one or more sessions of the forthcoming conference (called for October 10th) of the Governors and Chairmen with the Board should be devoted to a comprehensive discussion of 'Federal Reserve Credit Policy.'

"The Board shares this view, and following is the list of topics which it has been decided should form the basis of this discussion:

"1. What object should Federal Reserve credit policy seek to accomplish and by what test may we know that it is sound? (Discussion to be led by Messrs. Norris [Philadelphia] and Wills [Cleveland].)

"2. What relative importance should be given to the following factors in determining such policy?

- (a) Federal Reserve reserves.
- (b) Interest rates in the open market.
- (c) Interest charged by member banks.
- (d) Interest rates paid on time deposits.
- (e) Balance of trade and inward or outward movement of gold.
- (f) Credit conditions in, and exchanges with, leading foreign countries.
- (g) Volume of bank loans and deposits.
- (h) Business and industrial activity, present or prospective.
- (i) Commodity price levels.
- (j) Condition of security markets.

"(Discussion to be led by Messrs. Jay [New York] and Seay [Richmond].)

"3. What light does the experience of the Federal Reserve Banks throw on the value of different methods of making their credit and discount policy effective?

- (a) Discount rates.
- (b) Open market operations.
- (c) Discretion in rediscounting.
- (d) Credit examination of member banks.
- (e) Credit ratings of commercial borrowers.

“(Discussion to be led by Messrs. Strong [New York] and Perrin [San Francisco].)”

“4. What is the most practicable method of bringing about timely and competent consideration of matters of credit policy by all of the Federal Reserve Banks and effective action to obtain the results aimed at? (Discussion to be led by Messrs. McDougal [Chicago] and Curtiss [Boston].)”

“In order that the discussion of the general subject of credit policy at the forthcoming conference may be thoroughgoing, productive, and pointed, it is desired by the Board that careful preparation and study of the topics to be considered be made in advance of the conference, and also that there should be a preliminary exchange of views in written form. Assignments have therefore been made in connection with the program to those who are to start the discussion.

“Each Governor and Chairman to whom an assignment has been made as above, is requested to prepare a written statement on the assigned subject, not to exceed 1200 words in length. Each statement or paper should bear a title and a brief introductory paragraph setting forth the proposition or conclusion it is intended to establish. These papers should be mimeographed and copies should be mailed to all other members of the conference (Governors and Chairmen of Federal Reserve banks).

“Following the afternoon session devoted to the above program, it is proposed to devote an evening session to the question—

“What does the present business and credit situation indicate with reference to the prospective demand for credit and the need or advisability of any action at the present time by Federal Reserve Banks with respect to matters of credit and discount policy?”

“General discussion.

“Very truly yours,

W. W. HOXTON, *Secretary.*”

## (2) THE FEDERAL RESERVE BOARD'S SUMMARY OF THE CONFERENCE

### “Summary of Selected Topics:

“The following summary is a selection and condensation of statements made in the papers and memoranda prepared by Governors and Chairmen, with special reference to those points on which opinion is apparently divergent. The topics considered do not follow the order of the program.

#### “1. *Relation of credit policy to commodity price levels*

“Federal Reserve credit policy, should be directed to effecting steadier credit and price conditions'. This object should not be confused with stabilization of prices at present levels. 'No one can now predict or control the level at which prices will ultimately become stabilized. We should merely direct our policy (1) so as to prevent any serious inflation, and (2) in times of deflation and depression, so as not to impede those who wish to move forward by using more credit. Credit volume, of course, is not the only factor affecting price levels, but without more credit prices do not rise very far, and with less credit prices almost invariably fall.' In agreement with this position is the statement: 'Regulation of the volume of credit

(which may greatly affect prices) therefore becomes our greatest responsibility'.

"Another paper states that 'very little consideration should be given to commodity price levels. It is no part of the business of a Reserve Bank to seek to advance or depress the price of commodities'. Furthermore, 'the influence of changes in Federal Reserve bank rates has been greatly exaggerated, and their power to affect the price-level or control the amount of credit is not only very limited, but very slow in producing effects'. No policy, however, should be adopted that is likely to accentuate price fluctuations, and one test of the soundness of policy is whether it 'tends indirectly to stabilize prices by stabilizing credit conditions, and stabilizes credit conditions by checking inflation and deflation before disaster comes'. Another paper points to the limited control exercised by Federal Reserve policy over the movements and volume of credit and urges that 'it is manifestly impossible in a country so large and so governed as ours to assume that the Federal Reserve banks initiate or stop credit movements because of high or low prices, active or inactive business, etc.' The conclusion of another writer is that 'the inflation which started in 1919 and broke in 1920 was not controlled, and in my opinion could not have been controlled, by any policy which the Federal Reserve Banks could have adopted'.

*"2. Value and meaning of 'discretion in rediscounting' as a method of making credit policy effective*

"Two papers reach similar conclusions on this question. One concludes: 'Based on the experience of this bank, and giving due consideration to conditions prevailing, "discretion" in rediscounting is more effective in controlling credit situations than changes in discount rates.' The other says that Federal Reserve Bank 'credit and discount policy will be made effective through the exercise of discretion in granting rediscounts, and not through regulation by the discount rate.' Among the considerations on which discretion in granting or refusing rediscounts must be based are: (1) occasion for rediscounting, (2) soundness of member bank's condition, (3) integrity and skill of its management, (4) its seasonal rediscount program, (5) general business, banking and credit outlook.

"Another paper concludes that 'discretion' in granting discounts should be used merely to supplement regulation by rate, and then chiefly in sections where interest rates are high. 'In special cases and districts personal "discretion" will be inescapable, but its employment should be resisted and moderately used'. 'Discretion implies knowledge of details of member banks' business. Such discretion extended to all member banks would necessitate passing upon every loan and investment of every member, causing annoyance, criticism of the system, and possibly radical legislation. 'Discretion' when required should be exercised more as to the total borrowings of a member, rather than as to any specific use of the proceeds. 'Discretionary' control over borrowings by members, except to a limited extent when rate control is ineffective, will develop the desire to exercise still greater power.

*"3. Effectiveness of rate policy in controlling flow of credit*

"(1) 'The effective method of regulation demonstrated by long experience abroad is by the discount rate.'

"(2) 'The discount rate cannot be the major influence making the credit policy effective.'

"In support of the first statement:

"The rates established by the Federal Reserve Banks have been measurably effective in influencing the loaning policy of member banks.' And: 'The rate of discount of a reserve bank regulates in general how much member banks borrow, and consequently influences increases or decreases in the total volume of credit.'

"In agreement with the second statement: 'The experience of this bank has demonstrated that while increasing the discount rate may have an indirect influence in developing an attitude of caution, it will not be wholly effective in curbing a tendency toward excessive borrowing at Federal Reserve Banks.'

"It is recognized that the control exercised by regulation depends partly upon the condition of member banks. 'It is only when the banks generally are compelled to call upon Federal Reserve Banks that the power of the Federal Reserve Banks to exercise any control over credit begins, and it is at such times that the rates and the rate policy assume greatest importance.' And: 'Particularly is the influence of the discount rate slight during a period of liquidation such as began in 1920.'

*"4. Relation of discount policy to reserve position*

"There is a marked diversity of opinion regarding the relative importance of Federal Reserves in determining discount policy. The extremes are indicated by two statements:

(1) 'Too much emphasis cannot be placed upon the Federal Reserve reserves in fixing discount rates.'

(2) 'The reserve ratio of a bank or of the system is a very easy but a bad guide to discount policy.'

"In accord with the first statement, 'The rate to be charged for this assistance (to member banks and the open market) shall be determined by the percentage of gold reserve at the Federal Reserve Banks, as well as its trend.' The paper most insistent upon establishing a close relation between discount policy and reserves suggest a plan by which a series of rate advances are definitely related to declines in reserve ratios. This paper says: 'If, when their reserves were declining, it was the plain duty of Federal Reserve Banks to protect them by raising discount rates, which resulted in a curtailment of business, why then, when reserves have become exceedingly large, is it not likewise their duty to lower their rates and thus give a stimulus to business?'

"In contrast to this is the statement that 'it seems probable that a Federal Reserve Bank could render to its member banks substantially its full rediscount service by establishing a moderate rate of say 5 percent or 6 percent, and maintaining such a rate without change.'

"Another paper states that 'At the present time, when Federal Reserve Bank reserves are at a high ratio, and the reserves of member banks of the country are in excess of commercial demand and seeking investment in securities, it is obvious that the protection of the Federal Reserve Bank reserves cannot be the primary reason for fixing rates,

and that other reasons will and must naturally come to the fore.' Yet, when other factors 'combine to effect a drain upon the reserves, present or prospective, then the protection of Reserve Bank reserves would become the primary consideration.'

*"5. Relation of discount rates to rates charged by member banks*

"Opposing statements:

(1) 'I must express the conviction that no object can be accomplished, and no policy can be effective, unless the discount rates of the Reserve Banks are generally maintained at or above rates charged to the public, particularly during periods of expansion.'

(2) 'Our experience thus far confirms the contention that Federal Reserve discount rates will normally not be above and usually below the lending rates for the paper rediscounted.'

"Another paper supports the first statement: 'Federal Reserve Bank rates to their members must as a governing principle be based upon and bear a close relation to the prevailing rates for bank funds on line of credit paper current in any particular part of the country.'

"In general accord with the second statement: 'Discount rates have ordinarily a very limited effect upon the rate made by such members to their customers and were not intended to control the rate to the consumer, and do not, in fact, exercise such an influence.' Another writer says: 'I believe member banks should get accommodation for the necessary requirements of their customers at Reserve Bank rates; and that the rates they charge customers are of minor importance.'

*"6. Timeliness of rate changes, and method of consideration*

"The opinion is expressed that 'the real power of the Federal Reserve Bank would seem to be that which results from the wisdom it has exercised in taking the leadership of its members.' An object which credit policy should seek to accomplish is 'to give timely notice of any distinct change which is anticipated in credit conditions.' Changes in rates should be of a character which would indicate 'what way the current was running, how strongly it was running, and whether there was likely to be a change in its direction.' In agreement with this, another paper states that 'an advance in the discount rate, simply recording the accomplished fact of increased credit demand, could serve no important purpose, but an advance made as cautionary warning of an expected trend of increased demand, should serve as a steadying influence to those engaged in industry and commerce. If it be urged that those guiding a Federal Reserve Bank's policies cannot infallibly forecast the trend of credit demand, it may be said, in the first place, that mathematical precision is not necessary, and further, that the control of the ultimate banking reserves lays upon them the responsibility to be informed of the real trend of business and industry. The discount rate would be the natural medium of expressing their judgment of the credit outlook.'

"Two papers present plans for bringing about timely and competent consideration of matters of credit policy:

(1) 'Frequent conferences of the Governors and Chairmen of the Federal Reserve Banks with the Federal Reserve Board, or a small committee representative of the Board and the Banks, for the express purpose of considering credit conditions.'

(2) 'Local credit policies should be dictated, except so far as certain general principles of credit policy are concerned, by the Board of Directors of each Federal Reserve Bank. Open market operations should be handled by one or possibly two committees of Governors of certain of the Federal Reserve Banks within convenient reach. The general principles of credit policy in both cases to be laid down by the Federal Reserve Board.'

(3) SELECTIONS FROM PAPERS PRESENTED TO THE CONFERENCE

"I. What Object Should Federal Reserve Credit Policy Seek To Accomplish and by What May We Know That It Is Sound?"

George W. Norris, Governor, Federal Reserve Bank of Philadelphia:

"The Objective of Federal Reserve Credit Policy—

"The power of rate changes to affect the price level or to control the amount of credit is limited, and slow in producing effects. Such changes should be as infrequent as possible, and should seek to anticipate conditions that would necessitate greater changes. Changes must always be the expression of a judgment, and no absolute formula can be devised. The general purpose should be—

1. To give assurance to the public that an adequate supply of banking credit for productive enterprise shall at all times be available, at rates fluctuating as little as possible, and never prohibitive.

2. To indicate to the public the effect business, as it is at the time being conducted, is having upon the supply of credit, and to give timely notice of any distinct change which is anticipated in credit conditions.

". . . In the first place, that the effect of rate changes upon the earnings of Reserve Banks must be wholly ignored. In the second place, very little consideration should be given to commodity price levels."

\* \* \* \* \*

"Thirdly, while the reserve ratio of a bank or of the System is a very easy guide to discount policy, it is a very bad guide."

\* \* \* \* \*

". . . In the next place, it is perhaps well to notice and acknowledge that fact that the influence of changes in Federal Reserve Bank rates has been greatly exaggerated, and that their power to affect the price-level or control the amount of credit is not only very limited but very slow in producing effects.

". . . There have been in these Conferences repeated discussions of various phases of the discount problem, but this is the first time to my knowledge, that we have sought to determine the fundamental question of the object sought to be accomplished. It is obvious that the prevention of disaster, and not succor following disaster, is the goal of a successful credit policy."

\* \* \* \* \*

". . . Finally, I know of no test by which the soundness or unsoundness of a credit policy may be determined, except—Results. If a policy tends indirectly to stabilize prices by stabilizing credit conditions, and stabilizes credit conditions by checking inflation and deflation before disaster comes, it is manifestly sound. If it fails to accomplish those results it is either unsound in principle or mistakenly applied."

D. C. Wills, Board Chairman, Federal Reserve Bank of Cleveland :

"This brief statement on the above subject attempts to declare what the Federal Reserve Credit policy should be by defining the single object sought to be accomplished, viz: assisting or supporting member banks and the open market so as to enable them to handle all proper transactions arising out of the production, manufacture or distribution of goods. By defining this single object, a clear basis is furnished for discussion of related, but less fundamental, phases. . . ."

J. U. Calkins, Federal Reserve Bank of San Francisco :

*"Conclusions :*

"The function of banking is the finance of trade, and as clearly indicated by provisions of the Federal Reserve Act, the object of Federal Reserve credit policy is to facilitate the finance of trade, trade being used as a comprehensive term and including all the operations of production and the consequent commerce of distribution.

"When the inevitable fluctuations in production and distribution have been met with a minimum of economic or financial dislocation, the soundness of the credit policy will have been demonstrated.

"This subject covering only two questions does not afford opportunity for didactic discussion. It does not concern what a Federal Reserve credit policy should be or how it should be applied; but only what it should accomplish and how it should be demonstrated to be a sound policy. The other considerations are included in other subjects to be covered by discussion of detailed subdivisions, and it is, therefore, only possible to offer a few observations if trespass on later expositions is to be avoided.

"It is not difficult to state the object which Federal Reserve credit policy should seek to accomplish, as it is not difficult to state what an aeroplane stabilizer should accomplish. Neither is it difficult to say what demonstration would prove the soundness of a credit policy or the effectiveness of an aeroplane stabilizer. Anyone can say what an aeroplane stabilizer is desired for—that is, what it should accomplish—and doubtless eventually someone will devise one that will be effective. When time has afforded enough experience and some lessons from experiment, an effective credit policy will doubtless be evolved.

"No satisfactory mechanical substitute for human intelligence has yet been devised, and no policy which does not contemplate the widest latitude in application would be sound. A credit policy should be compounded by application of intelligence to scientific analysis and past experience. In order to accomplish the test which will demonstrate its soundness, it is obvious that Federal Reserve credit policy cannot be rigid; cannot be an academic or dogmatic formula to be applied by rule of thumb. A sound credit policy might be rendered partly or wholly ineffective by accident; by war or the consequences of war.

"A credit policy must provide support in case of increased demand for bank credit whether that increase be gradual and long continued or abrupt and temporary, and in either case should provide this support promptly and effectively. It should accomplish this in such a way as to allay apprehension and inspire confidence. Past experience in the Federal Reserve System indicates that this can be done; in

other words, that the System lends itself to inflation with a considerable degree of success—a fact that has caused no general complaint.

“A credit policy that would soften the rigors of depression would also be desirable, but that would mean painless deflation, and as deflation is anathema, it appears improbable that any credit policy will accomplish that result or even tend to popularize deflation.

“A Federal Reserve credit policy should facilitate necessary expansion of bank credit without strain and at the same time check or prevent unnecessary or excessive expansion, thereby decreasing the disastrous consequences of reaction.”

Joseph A. McCord, Board Chairman, Federal Reserve Bank of Atlanta :

“The main object to be attained in fixing the credit policy of Federal Reserve Banks should be to carry out as nearly as possible the title of the Federal Reserve Act, viz: ‘Provide for the establishment of Federal Reserve Banks to furnish elastic currency, to afford a means of rediscounting commercial paper, and to establish a more effective supervision of banking in the United States, and for other purposes.’”

\* \* \* \* \*

“There can be no fixed rule for the establishment of a credit policy. Officers of Federal Reserve Banks having charge of discounting, should study well the conditions of each member bank. They should also give attention to reserves of member banks, watching carefully and closely those banks that habitually have deficient reserves; admonition to that class of banks would materially aid in fixing a policy that would govern in handling the business of that particular locality in the district in which the Federal Reserve bank is located.”

B. A. McKinney, Governor, Federal Reserve Bank of Dallas :

“While the Act does not categorically define ‘the’ Federal Reserve credit policy, it does reveal in unmistakable language the intent of Congress with respect to the field in which the reserve banks were meant to function. Having constructed reservoirs in the twelve regions or districts and concentrated the reserve power of each district within that district, the law further provides in effect that the lending power of each bank shall be administered in a safe, reasonable and impartial manner, for the benefit, first, of the agricultural, live stock and commercial interests of the district served and, second, through the processes of inter-district rediscounting and open market transactions, for the benefit of the entire country.

“A secondary object of Federal Reserve credit policy should be the protection of sound credit practices on the part of member banks . . .”

C. A. Morss, Governor, Federal Reserve Bank of Boston :

“*Conclusions:*

“The object of this memorandum is to express my general agreement with the opinions expressed by Messrs. Norris and Wills in their answers to question 1.”

\* \* \* \* \*

“I think I should define the objective of the Federal Reserve credit policy—

1. To establish and maintain a sound and flexible currency.
2. To provide credit for the use of member banks in such quantity and at such rates as would tend to stabilize the flow of credit and the rates of interest to the business community.

"I do not understand that this statement of the object shows that I have any different opinions of what the objective should be than either Governor Norris or Mr. Wills, simply another way of putting it.

"If these objects can be obtained, we should always have an amount of currency adequate to the needs of the community which would never depreciate because it would never be redundant and because there would be at all times an adequate amount of security and gold reserve in the banks to protect the notes against any demand that might be made for their redemption. We should furnish all of the credit to our member banks which would be necessary to enable them to finance the movement of whatever volume of goods the needs of the country might require without any artificial pressure for the increase of credit or the decrease of credit that would affect prices. We should know that we had accomplished our objects when the business of the country moved on smoothly and evenly and with only very moderate indications of inflation or deflation. Since the beginning of the war in 1914 the business of the country and prices have been affected by such great forces outside of interest rates that the discount rates had very inadequate control over the flow of credit and the inflation which started in 1919 and broke in 1920 was not controlled, and in my opinion could not have been controlled, by any policy which the Federal Reserve Banks could have adopted. Even now, conditions are not stabilized in the sense that they were before the war began, especially when we consider the situation in Europe. At the present time, however, business in this country seems to be developing in such a way that its position may be placed in a well recognized business cycle. It would appear, therefore, that it is moving along in a fairly normal way and the policies of the Federal Reserve Banks should be adjusted to meet these conditions."

"II. What Relative Importance Should Be Given to the Following Factors in Determining Such Policy?

- A. Federal Reserve Reserves.
- B. Interest Rates in the Open Market.
- C. Interest Charged by Member Banks.
- D. Interest Rates Paid on Time Deposits.
- E. Balance of Trade and Inward or Outward Movement of Gold.
- F. Credit Correlation In, and Exchanges With, Leading Foreign Countries.
- G. Volume of Bank Loans and Deposits.
- H. Business and Industrial Activity, Present or Prospective.
- I. Commodity Price Levels.
- J. Conditions of Security Markets."

Mr. Jay, Board Chairman, Federal Reserve Bank of New York:

*"Conclusion:*

"Federal Reserve credit policy, as referred to in Topic 1, is taken to mean something broader than that Federal Reserve Banks should

always be sound and liquid, able to pay their obligations and lend to member banks. Federal Reserve credit policy should be directed to effecting steadier credit and price conditions. The following discussion indicates the relative importance of these factors in pursuing such a policy, but changing circumstances may at any time change their relative importance.

*“Discussion (G, H, and I).—*Bank credit is merely a means to an end . . . Therefore, our credit policy should aim to steady the volume of credit, since commodity prices move in such close correspondence to credit volume. In carrying out this policy these three factors are of fundamental importance, but our statistical information regarding them, especially production and distribution, is inadequate and must be improved.

*“Credit volume, of course, is not the only factor affecting price levels. Changes in government or private affairs, in methods of production and distribution, in supply or demand, or in the business state of mind, may raise or lower commodity prices. But without more credit prices do not rise very far, and with less credit prices almost invariably fall.”*

George J. Seay, Governor, Federal Reserve Bank of Richmond :

*“. . . The distress and losses to which very many people have been subjected as a result of a number of complex causes arising out of the war, the greatest emergency ever experienced in the banking business, have brought into existence many distorted ideas of the purposes for which the Federal Reserve System was formed, what it is able to accomplish and may reasonably and safely attempt to accomplish.”*

\* \* \* \* \*

*“The most dangerous idea, or conception, in connection with the System that has been put forward is that it controls the bank credit of the nation; the charge that it has exercised that control tyrannously grew out of that idea.”*

\* \* \* \* \*

*“We have had an example of the dangers of extending a volume of credit out of proportion to the volume of goods and the productive capacity and consumptive powers of the country which should last us for many, many years. It is undoubtedly true that too great a supply of credit will inevitably lead to inflation, and is in itself inflation, and unless new uses for credit arise to absorb the increased supply, harm and not benefit will result.”*

\* \* \* \* \*

*“Conclusions :*

*“Predicating conclusions upon the foregoing observations, the Discount Policy of Federal Reserve Banks should be considered under two headings: The Commercial Discount Rate and the Open Market Rate.*

*“The Commercial Discount Rate should be governed by the factors submitted for discussion, in the following order of relative importance :*

- 1 (c) Rates charged by banks to their customers.*
- 2 (b) Interest rates in the open market.*
- 3 (g) The volume of bank loans and deposits. (Indicative of the reserve position.)*

4(h) Business and industrial activity. (Presaging demand for credit.)

5(i) Commodity price levels (as affecting the volume of credit required, but not with view of price control).

6(j) Condition of security market (as indicative of supply of investment or floating capital).

7(d) Interest rates on time deposits. (This is merely a symptom of scarcity of capital.)

#### OPEN MARKET RATE

1(b) Open market rates (on bankers' acceptances).

2(e) Balance of trade and inward or outward flow of gold.

3(f) Credit conditions in, and exchange with, leading foreign countries.

#### PROTECTION OF FEDERAL RESERVE BANK RESERVE

"Finally: When the intricate play of these or other factors combine to effect a drain upon the reserves, present or prospective, then the protection of Reserve Bank reserves would become the primary consideration."

John H. Rich, Board Chairman, Federal Reserve Bank of Minneapolis:

"The Objective of Federal Reserve Credit Policy.

"The main objective of the Federal Reserve Bank is to afford service to its members. The Act gives it an extremely limited direct authority and very little mandatory power. It appears to me that the general purposes should be:

"1. To support and assist the productive enterprise of its district; to maintain a steady and dependable flow of credit to such well managed members as may need it, and,

"2. To mold its credit policy in such a way that it will serve as an efficient hand-maiden to changing economic and business conditions and the fluctuations to which those who are engaged in the production of goods and in agricultural and livestock production are subject. Its purpose should be to afford a broad underlying foundation capable of sustaining and stabilizing the activities of its district."

R. L. Austin, Board Chairman, Federal Reserve Bank of Philadelphia:

*"Conclusions:*

"1. That it is desirable that all Federal Reserve bank discount rates should be determined by uniform policy.

"2. That the reserve is the principal factor in determining a credit policy and indicates the ability of the Federal Reserve bank to extend service; therefore, the discount rate should be a distinct expression of that ability.

"3. That the Federal Reserve banks were organized to give flexibility to bank reserves and there should be no hesitation in using them whenever occasion requires.

"After carefully considering the Board's program for the discussion of the Federal Reserve credit policy, and having read the several papers that have been prepared by the Chairmen and Governors upon

these subjects, the impression has been obtained that Federal Reserve reserves are of the greatest importance in determining the credit policy of Federal Reserve banks. There appears to be, however, diversity of opinion upon this subject.

“Governor Seay’s paper concludes by giving a number of factors which he considers of greater importance in determining Federal Reserve bank credit policies than the Federal Reserve banks’ reserves, though in his paper we read, ‘At the height of the credit expansion, when reserves of Federal Reserve banks had seriously declined and the tendency toward further expansion was unmistakable and dangerous, the dominant purpose of Federal Reserve rates was to protect reserves,’ which was done by raising discount rates. This forced a contraction in business whereby the demands for credit were lessened and reserves increased, or, at least, were not depleted further. He continues—‘At the present time, when Federal Reserve bank reserves are at a high ratio and the reserves of member banks of the country are in excess of commercial demand and seeking investment in securities, it is obvious that the protection of Federal Reserve bank reserves cannot be the primary reason for fixing rates, and that other reasons will and must naturally come to the fore.’ Has he not, however, failed to reach a proper conclusion by neglecting to give sufficient consideration to the accumulation of reserves in fixing discount rates? If, when their reserves were declining, it was the plain duty of the Federal Reserve banks to protect them by raising discount rates, which resulted in a curtailment of business, why then, when reserves have become exceedingly large, is it not likewise their duty to lower their rates and thus give a stimulus to business? Can anyone deny that there is an almost irresistible force, inherent in accumulated reserves, which must result in lower discount rates unless they are artificially controlled? Discount rates are an expression of a bank’s ability to extend service in the way of selling credit, and there is no better way of determining that ability than by its reserves. The changing of discount rates is always notice to the business community that there is an increase or decrease in the amount of service a bank has to sell, and the business community never fails to take note of it.

“In his paper, Governor Norris makes the statement that ‘the reserve ratio of the system is a very easy but a bad guide for discount policy.’ ‘If it were followed,’ he says, ‘rates would have to be lowest at the end of a prolonged period of easy money and highest at the time of crisis.’ One is inclined to ask if any other condition is possible, and if all the history of finance does not confirm it. He believes that low rates for money never fail to develop speculation and inflation, forgetting that such times have no attraction for the so-called speculator, and do not develop speculation. The buyers then are those who know the real value of goods and realize when bargains can be obtained. In opposition to Mr. Norris’ statement, Mr. Perrin says, “In the face of falling prices and business curtailment, fear is not justified that radical and rapid reductions in the discount rate will revive speculative enterprise.’ Governor Norris further states “There is reason to hope that bankers and the business community will gradually become accustomed to watching the reserve position and discount rates of the reserve banks and will appreciate what changes in these mean,’ evidently placing

real value on the reserves of the Federal Reserve banks as a determinant of policies.

"There can be no doubt that the credit policy of the Federal Reserve system should be such as to appeal to the public as being sound and based in all districts upon uniform principles. Hence I believe that too much emphasis cannot be placed upon Federal Reserves in fixing discount rates. The following table sets forth the reserve ratios and discount rates of the twelve banks as of September 13—

	Reserve ratio	Discount rate
Boston.....	75.2	4
New York.....	83.7	4
Philadelphia.....	73.5	4½
Cleveland.....	69.5	4½
Richmond.....	79.3	4½
Atlanta.....	82.3	4½
Chicago.....	89.2	4½
St. Louis.....	63.5	4½
Minneapolis.....	73.2	4½
Kansas City.....	65.3	4½
Dallas.....	62.1	4½
San Francisco.....	67.2	4

"It will be noticed that Boston and Philadelphia with practically the same reserves have dissimilar rates of discount; that San Francisco with a reserve of 67 percent has the same discount rate, 4 percent, as New York with a reserve of 83.7 percent, and ½ percent less than Richmond, Atlanta or Chicago, whose reserves are 79, 82 and 89 percent respectively; and that Chicago with a reserve of 89 percent has the same rate as Dallas, Kansas City and St. Louis, whose reserves are 62, 65 and 63 percent respectively.

"On numerous occasions the question has been put to us, 'Why is the discount rate in Philadelphia 4½ percent and in Boston only 4 percent although the reserve positions of the two banks are almost identical?' Since the banking position of the two institutions is almost exactly the same, and since the economic and business situation of the two districts are so similar, the answer to the question has not been easy. The answer, of course, lies in the different attitudes of the directors of the reserve banks, and the different conclusions reached by them. The table indicates clearly the lack of any uniformity in determining discount rates, and it would be well if we could arrive at some uniformity. This does not mean that the rates at all times should be uniform throughout the country, but that the directors of the various banks should work from a uniform basis and follow the same principles in fixing the discount rates. Specifically, this suggestion might be formulated into a plan, having the discount rate depend upon the reserve ratio in somewhat the following relation—

Reserve ratio (percent)	Discount rate (percent)
45.....	6
50.....	5½
55.....	5¼
60.....	5
65.....	4¾
70.....	4½
75.....	4¼
80.....	4
85.....	3¾

"It is hard to see how the public can fail to be impressed with the apparent weakness in the credit policy of the System when it notes that there is so little relation between the reserve positions of the various Federal Reserve banks, and their discount rates. If we could agree on some plan that would effect uniformity and have the rates correspond more with the condition of the banks, it would remove from our rate making the element of the lack of principle that it now seems to have, confidence would be gained in our policy, and it would be much less subject to criticism.

"Any rates so determined would hold good for the cities and the financially stronger sections of the country. To the discretion of the individual reserve banks would be left the settlement of such local problems as might be presented by the extremely high rates prevailing in country districts and by the tendency upon the part of a relatively small number of banks to make use of the Federal Reserve discount facilities for profiteering through rate differentials.

"In conclusion, I should like to emphasize again the thought that there should be no hesitation in lowering discount rates when the reserve positions of the banks warrant it. If the reserves of the Federal Reserve banks continue to increase in spite of lowered rates it can be taken as evidence that business is still restricted, is abnormally low, and if it can be stimulated by lower rates it is hard to conceive of any good reason for not administering the stimulant."

William McC. Martin, Sr. Chairman of the Board, Federal Reserve Bank of St. Louis:

"As the experience of the System has been mainly with war and post war conditions, any discussion of the relative importance of the above-mentioned factors must be chiefly theoretical, as we have had practically no experience under normal conditions.

"It would seem that the relative importance will change not only with different times but with different conditions within the respective districts themselves.

"It is of the utmost importance that the chief controlling factors should be worked out in a language that both the public and the Federal Reserve banker can understand, so that the establishment of a credit policy has no mystery and requires no explanation.

"*Discussion.*—In August 1914, war was declared abroad. Federal Reserve banks were opened for business on November 16 of that year, and during the two and a half years succeeding, which were as unaffected by disordered conditions as any the System has ever known during its existence, member banks though being educated to the uses of the System did not have a real working knowledge of it. In April, 1917, this country itself went into the war and since then our experience has been that of a war and post war period. Economics as a science is only systemized knowledge based on experience, and as we have had practically no experience based on normal conditions, our discussion in the main must be theoretical.

"This topic has been discussed in an admirable and scholarly way by both Mr. Jay and Mr. Seay. Their discussions are in agreement on the essentials. There is no question but that the underlying purpose of a credit policy should be to bring about steadier credit conditions and thereby stabilizing price conditions. And there is also no ques-

tion but that the member banks should be able to call on reserve banks for reasonable and legitimate credit for customers, but not for the primary purpose of relending at a profit. The problem is a difficult one for all of us, but it seems to me less difficult in a center like New York than in an agricultural center like Richmond. Therefore, as is natural, while New York does not omit the necessity of considering the rate charged by member banks to its customers, Mr. Jay puts chief emphasis on the consideration to be given the open market rate. On the other hand, Mr. Seay, representing conditions more clearly apparent in the majority of the banks in the System, while he gives due consideration to the open market rate, emphasizes the necessity of considering as one of the prime factors the rate charged by a member bank to its customers. It is, of course, not only wrong but highly dangerous to encourage the idea, unfortunately too common, that the Federal Reserve Banks control rates charged to customers by member banks, but the rates of the Federal Reserve Banks should stabilize rates charged by member banks to customers, and a discussion of them must be given a large part in considering a credit policy, at least by a majority of the Federal Reserve banks.

"Such portion of the public as think of these matters undoubtedly consider the reserve percentage as the chief factor in judging the credit policy of a Federal Reserve bank. When the raising or the lowering of the Federal Reserve discount rate is not in approximate accord with this percentage a change in the rate can be easily misunderstood. If a reserve percentage could be worked out so as to be approximately indicative of all the factors that go into the establishment of a credit policy, it would be a long step in the right direction."

"III. What Light Does the Experience of the Federal Reserve Banks Throw on the Value of Different Methods of Making Their Credit and Discount Policy Effective?

- A. Discount Rates.
- B. Open Market Operations.
- C. Discretion in Rediscounting.
- D. Credit Examination of Member Banks.
- E. Credit Ratings of Commercial Borrowers."

B. Strong, Governor, Federal Reserve Bank of New York (No. 1) :

*Conclusion :*

"The rate of discount of a Reserve bank regulates in general how much member banks borrow, and consequently influences increases or decreases in the total volume of bank credit. But in sections where interest rates are high, discount rates may not always prevent over-borrowing by member banks and some personal control cannot be avoided."

\* \* \* \* \*

"Economic well-being depends, among other things, upon an even flow of production and consumption of goods which, in turn, depends upon stability of conditions which affect production and consumption. The most important element requiring stability is the price level. Sudden and wide variations in prices tend to disturb production and consumption. Trade becomes risky and speculative.

"Of the various causes of price changes, none are so potent as changes in the volume of 'money' that is of credit and currency."

\* \* \* \* \*

". . . By what methods shall we be guided so as to avoid undesirable inflation and contraction, promote credit and price stability and so serve the entire business community ?

"Open market investments are not controlled by rates but by 'discretion' alone. They cause credit expansion as fully as do loans, and should be governed by system credit policy, rather than by the desire of individual reserve banks to make earnings. Aside therefore from our investments and gold movements, changes in the total volume of credit are now brought about almost exclusively by our loans to member banks. Every increase in our earning assets lays the foundation for a credit pyramid, estimated roughly in the ratio of eleven to one (see studies of W. M. Persons, Harvard Review of Economic Statistics, January, 1920) Low discount rates which cause borrowing therefore have a cumulative effect upon credit volume and may in turn affect prices, even though the ratio of eleven to one may not be reached. The obverse is equally true. High discount rates which cause repayments to reserve banks will, in turn, influence liquidation of bank loans and deposits and retirement of currency by the banking system as a whole in somewhat the same ratio, and likewise affect prices."

\* \* \* \* \*

"The tendency to create Government agencies to supervise business is increasing. These Commissions and Boards exercise a great variety of statutory powers, often futile. Each is subject to the human weakness that once given power men seek to enlarge their powers. Reserve banks are no exception.

"The writer believes that 'discretionary' control over borrowings by members, except to a limited extent when rate control is ineffective, will develop the desire to exercise still greater power, and that the Reserve System, instead of being a democratic smoothly-working co-operative organization, regulating the volume and flow of credit and currency principally by adjusting its rates as conditions and public welfare require, might become a financial bureaucracy, vainly attempting to dominate the banking system by methods which are obnoxious to every instinct of the American people. In special cases and districts personal 'discretion' will be inescapable, but its employment should be resisted and moderately used. The effective method of regulation demonstrated by long experience abroad is by the discount rate. The rate will be effective with the great mass of banking resources and only limited and judicious use of 'discretion' will be needed, and then only in those sections where general interest rates are high."

J. Perrin, Chairman, Federal Reserve Bank of San Francisco :

*"Conclusion :*

"Discount rates of Federal Reserve banks will normally not be above the rates borne by paper which they rediscount.

"Their credit and discount policy will be made effective through the exercise of discretion in granting rediscounts, and not through regulation by the discount rate."

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*“Regulation of Rediscounts by Discretion.*—The conclusion is unavoidable that the only practicable method of making its credit policy effective lies in a Federal Reserve Bank’s exercise of discretion in granting or refusing each particular rediscount. This discretion must be based upon substantially the same considerations which influence a commercial bank in granting or refusing loans, barring the value of deposit balances. In a general way these would include information as to the occasion for rediscounting, the soundness of the member bank’s condition, obtained through examinations and credit investigations, and integrity and skill of its management, its seasonal rediscount program, the success of the bank in living up to previous programs, and the general business banking and credit outlook. Paper offered would be scrutinized to determine its eligibility, probable liquidation at maturity and ultimate collectability regardless of the rediscounting bank’s endorsement.”

B. Strong, Federal Reserve Bank of New York (Number 2) :

“Mr. Perrin’s very able memorandum graphically exhibits the difficulties of adopting a rate policy which will be effective in various sections where prevailing rates of interest are so widely different. In general I agree with his views as to the difficulties and, with some exceptions, with his statement that a comparison of the effect of the discount rate of the Bank of England with the effect of the rates established by Federal Reserve Banks, is liable to be misleading.

“On the other hand, his argument appears to be addressed to the view that the obligation of Reserve Banks is confined to extending the amount of credit which is justly needed to each member bank, but no more credit than each member bank is entitled to receive. This is the implication of the section of the statute which he quotes as follows :

“The directors . . . shall . . . extend to each member bank such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks.”

“His conclusion appears to be that the responsibility of the Reserve Banks is in fact limited to insuring that each member gets all the credit that it can justly claim and no more than it is entitled to receive. Upon this theory it would be impossible for the Federal Reserve System to insure that collectively all of the 10,000 members receive all of the credit to which they are collectively entitled and no more than the community as a whole needs. Each application would be disposed of upon the basis of the soundness of each individual member bank in each of the twelve different Districts, and the integrity of the management and the individual needs of each bank, regardless of the general credit conditions prevailing in each of the twelve separate districts as a whole. Credit control in the big sense would be absolutely lost in a maze of individualities in which the Reserve Bank officers would be struggling helplessly. Upon that theory, what is the responsibility of the Federal Reserve System to the nation as a whole, as to inflation? Would it mean that upon providing its claim each member bank would be entitled to receive, upon some pro rata basis, its proportion of the whole lending power of the System? The surplus reserves of the Federal Reserve Banks today give them a lending power capable of bringing about an expansion of many billions of

dollars and causing such an advance in the prices of everything as would involve an economic readjustment for the whole country of the first magnitude and result in calamity. Is this grave problem of expansion to be considered upon the narrow theory presented in Mr. Perrin's paper? Can it possibly be claimed that the responsibility of the Federal Reserve System for credit stability can be predicated upon a microscopic scrutiny of all the business conducted by each member bank so as to determine exactly what proportion of the Reserve System's credit it is entitled to receive? What standards are to be adopted in deciding how much each member bank is entitled to receive? Who is to exercise the 'discretion' as to what loans by member banks are justified and proper, and what loans should not be made in case the result of their making should be further borrowing from the Reserve Bank? In fact, where lies the authority in the Reserve Act for anyone to make and enforce these important decisions?

"In ordinary times, with gold moving freely among the nations the effect of too low a discount rate would be an expansion of bank credit, advances in prices, heavy imports of goods and exports of gold, with the unescapable necessity for raising discount rates to protect reserves. No other action could control the gold movement. Can it be contended that in these extraordinary times the managements of the twelve Reserve Banks can effectively exercise such 'discretion' as to the need for borrowings by individual member banks so that complete control of credit expansion by all banks may be exercised when, in fact, no gold exports, which in normal times would force rate advances, can take place?

"The twelfth Federal Reserve District, because of its enormous territory and the wide range of interest rates in the different sections of the district, presents probably the greatest difficulty as to discount rates of any Federal Reserve District. In contrast, the New York District is the most compact in proportion to resources and contains, probably, the smallest variation in interest rates in the different sections of the district of any Federal Reserve District.

"While, therefore, it is natural that the more extreme views on this important matters should originate in these two districts, I am nevertheless, firmly convinced, in fact even confirmed in the view expressed in my first paper, since reading Mr. Perrin's paper, that the great mass of borrowing from the Federal Reserve Banks must be controlled by the rate of discount; that the rate of discount can, in fact, be made effective as to the great mass of bank credit, and that this will be particularly true in the larger cities of the San Francisco District, and of all other Federal Reserve Districts. Any other policy than reliance upon rates, with such exceptions as are made necessary by the conditions discussed both in Mr. Perrin's paper and my own, would, in my opinion, result in a situation where, instead of effective control of credit, we would have no country-wide control, but rather an attempt at control of the affairs of each member bank, which would be obnoxious and perilous.

"This policy of personal control was attempted in part in the years 1919 and 1920 and signally failed. Its extension throughout the System as a System policy would not only fail as a means of regulating credit, but would gradually develop in an effort to regulate the affairs of each member bank by the exercise of personal discretion which

would subject the System to severe complaint by its members; to political attack by Congress; and ultimately, to its downfall.”

D. C. Biggs, Governor, Federal Reserve Bank of St. Louis:

“The credit and discount policy of a Reserve Bank cannot be effectively controlled by its discount rate alone.

“A certain measure of control must be exercised through discretion in the amount that a member bank is permitted to borrow, but not through discrimination against individual pieces or classes of eligible paper.

“In theory, at least, the discount rate of a Federal Reserve Bank should be higher than the market in the financial centers in the several districts of the country. If this theory could be put into practice, the rediscount rate would prove effective in carrying out a credit and discount policy, for there would be a penalty instead of a profit in borrowing. The rate of discount established by banks varies according to the class of paper, the section of the Country, and the established custom and policies of years. For example: Prime bankers’ acceptances, on which the Bank of England primarily bases its discount rate, is one class; another class is prime commercial paper nationally known; a third class may be commercial paper sold locally; while a fourth class would be the ordinary run of loans of a country bank, with the rate of interest depending upon local conditions and customs.

“While Reserve Banks may exercise some control thru their discount rate on open market purchases, they are, by law, obliged to discount all classes of eligible paper offered by member banks in one district at the same rate. The rate, therefore, for one district cannot control the credit policy of that district on account of its carrying various classes of paper.

“Judicious discretion in the total rediscounts of a member bank and not discrimination against classes of eligible paper should be used at the beginning of the period of inflation, and not delayed until the movement has fully developed, and while it is difficult to determine when such movement begins, certain signs should be evidence to the Reserve Bank, not only because of its knowledge of general business and banking conditions, but because of the intimate knowledge it has of the condition of the member banks from the reports of examination.”

E. Fancher, Governor, Federal Reserve Bank of Cleveland:

*“Conclusion:*

“Based on the experience of this bank, and giving due consideration to conditions prevailing, discretion in rediscounting is more effective in controlling the credit situation than changes in discount rates.”

C. Hardy, Chairman, Federal Reserve Bank of Richmond:

*“Conclusion:*

“Whatever may be the effect of the reserve bank rate on the borrowings of member banks in the large commercial centers and in those sections in which the lending rates of member banks are sensitive to the rise and fall of the credit supply; in other sections where the lending rate is seldom, if ever, lower than the legal rate, the exercise of discretion in rediscounting is necessary. This is particularly true in any section in which the legal rate is more than 6 percent, because

such a circumstance is indicative of an inadequate supply of local banking capital."

W. A. Heath, Federal Reserve Bank of Chicago :

*"Conclusion:*

"The rates established by the Federal Reserve Banks have been immeasurably effective in influencing the loaning policy of member banks; the open market operations of the Federal Reserve Banks, while encouraging the legitimate use of the acceptance privilege, have at times apparently prevented the accomplishment of an equally important object, namely, the wide distribution of the bills themselves."

W. F. Ramsey, Chairman of the Board, Federal Reserve Bank of Dallas :

*"Conclusion:*

"In practice it has been found that the effectiveness of reserve bank's credit and discount policy does not depend wholly, and under some circumstances not even chiefly, upon the power to control its discount rate. Our experience has taught us that such control is based quite largely upon a carefully studied administrative supervision of the credit practices as well as credit demands of each borrowing member. Such control is made both effective and helpful by judicious use of all legitimate sources of publicity in keeping the banks, as well as the general public, informed as to the proper scope of a reserve bank's lending power, the general trend of financial and business conditions, and the necessity of conservatism in the extension of credit."

R. A. Young, Governor, Federal Reserve Bank of Minneapolis :

*"Conclusions:*

"1. That too great a use of credit by banks for capital, investment or speculative purposes rather than the necessary use of credit to aid in the production, manufacture and distribution of products causes dangerous inflation.

"2. That these conditions develop before the reserves of the Federal Reserve System are used by member banks to any great extent.

"3. That a discount rate slightly above, equal to or even slightly below the prevailing rates on prime commercial paper is sufficient to prompt banks in the larger centers to discriminate in the use of credit and stop inflation. Indirectly this action by the banks in the larger cities affects the banks in the smaller places.

"4. After inflation is checked and deflation starts no harm can come to the banks and much good to legitimate business in reducing the rediscount rate in anticipation of a lower commercial rate.

"5. In the future, increasing the rate because of seasonal requirements alone would be wrong but when Federal Reserve Banks learn that credit is being used for capital, investment or speculative purposes to any unwarranted extent, (even though their reserves have not been used by member banks to any great extent) the rediscount rate should be raised sufficiently to aid in avoiding a repetition of the disastrous results that came to all business in the years 1919 and 1920.

"In June, 1914 the combined deposits of all banks and trust companies in the United States were approximately \$20,000,000,000.00 and the loans and discounts approximately \$15,000,000,000.00.

“By June, 1917, the deposits amounted to \$30,000,000,000.00 and the loans and discounts amounted to \$20,000,000,000.00. In June, 1917 the total accommodation extended by Federal Reserve Banks only amounted to approximately \$200,000,000.

“In June, 1919 the total deposits of all banks in the United States amounted to approximately \$34,000,000,000.00 while the loans and discounts amounted to \$25,000,000,000.00.

“While it is reasonable to believe that a certain natural increase in deposits occurred it is no more than fair to assume that a large part of the increase in deposits of \$14,000,000,000.00 from June, 1914 to June, 1919 was occasioned by the increase in loans of \$10,000,000,000.00, pyramiding contributing in no small way. In June 1919 the Federal Reserve Banks had extended to member banks a total accommodation of approximately \$1,800,000,000.00 of which, however, \$1,600,000,000.00 was represented by paper secured by Government obligations. In June 1919 the highest rate of discount charged by any Federal Reserve Bank on commercial paper was 5%. The highest rate on paper secured by Victory notes was  $4\frac{1}{2}\%$  and notes secured by other Government paper,  $4\frac{1}{4}\%$ . No one of these rates inflicted a penalty upon member banks' borrowings. In December, 1919 rates were established which made borrowings by banks on their own Government securities unprofitable and it is interesting to note that from December, 1919 to November, 1920 the amount of paper held by Federal Reserve Banks secured by Government obligations decreased from \$1,700,000,000.00 to \$1,200,000,000.00. It is equally interesting to note that between June, 1919 and June, 1920, when the rediscount rate of Federal Reserve Banks was much below the prevailing average commercial rates, that the total bills discounted for member banks represented by commercial, agricultural and livestock paper increased from approximately \$200,000,000.00 to \$1,100,000,000.00. Seven percent discount rates were established by a number of the Federal Reserve Banks in June, 1920 and while the peak load was reached in November of that year the 7 percent rate was high enough to bring the liquidation that came very rapidly after November, 1920.

“After the inflation had been checked and deflation started it is interesting to note that the total accommodation extended to member banks after May, 1921 continued to decrease even though the Federal Reserve Banks reduced their rediscount rate, below the prevailing average commercial rate.”

“IV. What is the Most Practicable Method of Bringing About Timely and Competent Consideration of Matters of Credit Policy by All of the Federal Reserve Banks and Effective Action to Obtain the Results Aimed at?”

J. B. McDougal, Governor, Federal Reserve Bank of Chicago :

*Conclusion:*

“Timely and competent consideration of matters of credit policy by all of the Federal Reserve Banks and effective action to obtain the results aimed at can best be secured through frequent conferences of the Governors and Chairman of the Federal Reserve Banks with the Federal Reserve Board, or a small committee representative of the

Board and the banks, for the express purpose of considering credit conditions.

*Discussion.*—The object to be accomplished by Federal Reserve Credit Policy, the relative importance of the several factors to be considered in determining such policy, and the value of different methods of making a credit and discount policy effective are presumed to have been fully covered under the first three main divisions of the general subject, Federal Reserve Credit Policy. Under these circumstances, it is assumed that there is left to Mr. Curtiss and myself the responsibility of recommending the most practicable method of securing timely and competent consideration by all of the Federal Reserve Banks of all important factors entering into the question of Federal Reserve Credit Policy; and the further responsibility of recommending a plan of action to obtain the results aimed at.

“After carefully considering the subject I have but one firm recommendation to make, that which is expressed briefly in the conclusion. Realizing the inconvenience and expense involved in bringing together at more frequent intervals a body of thirty-two men from all parts of the country for the express purpose of considering credit conditions, it is suggested that there be appointed a small committee representative of the Board and the banks, drawn from different sections of the country with a view to fairly reflecting the sentiment of the country as a whole; this committee to receive reports from all the Federal Reserve Banks and other sources with respect to current conditions affecting the use of credit, to meet as often as circumstances seem to justify, and to keep all members of this conference informed.”

F. H. Curtiss, Chairman, Federal Reserve Bank of Boston :

*Conclusion:*

“Local credit policies should be dictated, except so far as certain general principles of credit policy are concerned, by the Board of Directors of each Federal Reserve Bank. Open market operations should be handled by one or possibly two committees of Governors of certain of the Federal Reserve Banks within convenient reach. The general principles of credit policy in both cases to be laid down by the Federal Reserve Board.

“There would appear to be two distinct classes of credit policy to be considered in the Federal Reserve System—

1. That dealing with the credits as they pertain to the local or Federal Reserve District, under Section 13 of the Federal Reserve Act, and,
2. That dealing with the credits as they pertain to the open market operations, under Section 14 of the Federal Reserve Act.

“As to the district or local credit policy, that should be left to the Board of Directors of each Federal Reserve Bank to determine, subject to supervision by the Federal Reserve Board. The Federal Reserve Board should agree on certain general principles of credit policy, which it should see that the officials of the Federal Reserve Banks understood and were expected to follow. So far as the determination of discount rates and other matters of credit policy are concerned, the officers of each Reserve Bank should be in closer touch with the needs of their district than the Federal Reserve Board could possibly be and, therefore, if the management of a Federal Reserve Bank is of a proper

character, the question of timely and competent consideration would be a matter of good judgment only so far as the local credit policy is concerned.

“The matter of credit policy, so far as open market operations are concerned, and other operations that pertain to the national, international and Federal Reserve System policies, I believe should be handled by a committee, possibly two committees, of the operating officers of the Reserve Banks—the Governors—one committee to handle the policies that deal with government obligations, to work in close touch with the Treasury, and the other to handle open market operations in bankers’ acceptances. There should be the closest cooperation between these two committees. Here again, the Federal Reserve Board should outline or approve general principles of credit policy for these committees, in order that open market operations should be uniform as to each district, and under the supervision of the Federal Reserve Board, to whom these committees would make periodical reports.”

(4) EXCERPTS FROM TENTH ANNUAL REPORT OF THE FEDERAL RESERVE BOARD (1923), PAGES 29-39

“GUIDES TO CREDIT POLICY”

“It is to the reserve ratio that the public in most countries looks to get an indication of changes in the banking position and in the credit situation. This habit of looking at the reserve ratio as an indicator is particularly prevalent in the United States, because the United States is more than any other the country of legally regulated reserves. However theoretically imperfect any reserve ratio may be as a credit and banking index even in normal circumstances, and however defective reserve ratios may have become as a result of the suspension of the gold standard in many countries, the reserve ratio is nevertheless the one banking index that has uninterruptedly enjoyed the prestige of tradition, and there is little or no indication of the displacement of this tradition in the near future. The reserve ratio must, therefore, be reckoned with as a fact in banking administration.

“In thus recognizing the importance generally attached by the business public to changes in the reserve ratio as an index of the banking position, the board is not oblivious of, nor indifferent to, the fact that central bank practices associated with an effective international gold standard are now inoperative and that this seriously affects the serviceability of reserve ratios as working guides in credit and currency administration.

“The reserve ratio cannot be expected to regain its former position of authority until the extraordinary international gold movements which, in part, have occasioned and in part have resulted from the breakdown of the gold standard, have ceased and the flow of gold from country to country is again governed by those forces which in more normal and stable conditions determine the balance of international payments. The gold standard as a regulatory influence can not be effective for one country alone, no matter how impregnable its gold position. Gold movements in the years before the war were in response to changes in the trade and financial position of countries operating on the gold standard, and the changes in the reserve ratios of the central

banks, which reflected these movements, were therefore indicative of trade movements and current banking and credit developments. A decline in the reserve ratio reflected either a growth in the liabilities arising chiefly from domestic business or a loss of reserves owing to an unfavorable balance of international payments. Under an effective international gold standard the movements of gold among the money markets of the world exercised a corrective influence on exchange rates, tended to equalize money rates in various countries, and to keep domestic price levels in line with the world price level. In these circumstances, changes in the reserve ratios of the various central banks served as valuable indicators of the changes in the credit and trade relations of the countries and were consequently important guides in the shaping of discount policies. Under the present conditions, with gold embargoes in force in most foreign countries and the United States practically the only free gold market of the world, the movement of gold to this country does not reflect the relative position of the money markets nor does the movement give rise to corrective influences, working through exchanges, money rates, and price levels, which tend to reverse the flow. The significance which movements in the reserve ratios formerly possessed rested upon the fact that they were the visible indicators of the operation of the nicely adjusted mechanism of international finance. With this mechanism now inoperative, the ratios have lost much of their value as administrative guides. It has therefore been necessary for banking administration even in those countries that have been most successful in maintaining a connection with the gold standard to develop or devise other working bases. This has been as true in the United States where the gold standard has been consistently maintained as in other countries where that standard is for the time being inoperative.

“The anomalous situation thus confronting central banking administration in all countries has led to much discussion in the United States and elsewhere as to workable substitutes for reserve ratios as guides to credit and currency administration. Particular prominence has been given in discussions of new proposals to the suggestion frequently made that the credit issuing from the Federal reserve banks should be regulated with immediate reference to the price level, particularly in such manner as to avoid fluctuations of general prices. Entirely apart from the difficult administrative problems that would arise in connection with the adoption of the price index as a guide and entirely apart from the serious political difficulties which would attend a system of credit administration based on prices, there is no reason for believing that the results attained would be as satisfactory as can be reached by other means economically valid and administratively practicable. In saying this the board is not unmindful of the abundant evidence recent years have given of the economic and business disturbances occasioned by violent fluctuations of prices. But it must not be overlooked that price fluctuations proceed from a great variety of causes, most of which lie outside the range of influence of the credit system. No credit system could undertake to perform the function of regulating credit by reference to prices without failing in the endeavor.

“The price situation and the credit situation are no doubt frequently involved in one another, but the interrelationship of prices and credit is too complex to admit of any simple statement, still less of a formula

of invariable application. An oversimplified statement of complex problems contributes nothing toward the development of an effective administrative procedure. It is the view of the Federal Reserve Board that the price situation and the credit situation, while sometimes closely related, are nevertheless not related to one another as simple cause and effect; they are rather both to be regarded as the outcome of common causes that work in the economic and business situation.

“The same conditions which predispose to a rise of prices also predispose to an increased demand for credit. The demand for credit is conditioned upon the business outlook. Credit is created in increasing volume only as the community wishes to use more credit—when the opportunity for the employment of credit appears more profitable. Sometimes borrowers want to borrow more and sometimes they are content with less. Sometimes lenders are ready to lend more and at other times less. Why this should be so depends on all those multifarious conditions and circumstances that affect the temper of the business community. For the most part these conditions lie beyond the radius of action of the Federal reserve banks. When the business outlook is inviting business men are apt to adventure and new business commitments are made in increasing volume. But only later will these commitments be reflected in the possible rise of prices and an increase in the volume of credit provided by the commercial banks of the country. The Federal reserve banks will not to any considerable extent feel the impact of the increased demand for credit until the whole train of antecedent circumstances which has occasioned it is well advanced on its course; that is, until a forward movement of business, no matter from what impulse it is proceeding, has gained momentum.

“Credit administration must be cognizant of what is under way or in process in the movement of business before it is registered in the price index. The price index records an accomplished fact. Good credit administration in times of active business expansion should not encourage or assist the excessive accumulation of forward commitments in business and banking which only later on will definitely reflect the rate at which they have been taking place in resulting changes of credit volume and changes of price levels; and in times of business reaction should discourage enforced liquidation of past commitments which also will only later on reflect the rate at which it has been taking place in altered credit volume and price levels. The problem of efficient credit administration is, therefore, largely a question of timeliness of action.

“No statistical mechanism alone, however carefully contrived, can furnish an adequate guide to credit administration. Credit is an intensely human institution and as such reflects the moods and impulses of the community—its hopes, its fears, its expectations. The business and credit situation at any particular time is weighted and charged with these invisible factors. They are elusive and cannot be fitted into any mechanical formula, but the fact that they are refractory to methods of the statistical laboratory makes them neither nonexistent nor nonimportant. They are factors which must always patiently and skillfully be evaluated as best they may and dealt with in any banking administration that is animated by a desire to secure to the community the results of an efficient system. In its ultimate analysis credit administration is not a matter of mechanical rules, but is and must be a

matter of judgment—of judgment concerning each specific credit situation at the particular moment of time when it has arisen or is developing.

“There are among these factors a sufficient number which are determinable in their character, and also measurable to relieve the problem of credit administration of much of its indefiniteness, and therefore give to it a substantial foundation of ascertainable fact. In large part these factors are recognized in the Federal reserve act. The act, therefore, itself goes far toward indicating standards by which the adequacy or inadequacy of the amount of credit provided by the Federal reserve banks may be tested.

“The Federal reserve act has laid down as the broad principle for the guidance of the Federal reserve banks and of the Federal Reserve Board in the discharge of their functions with respect to the administration of the credit facilities of the Federal reserve banks the principle of ‘accommodating commerce and business.’ (Sec. 14 of the Federal reserve act, par. (d)) The act goes further. It gives a further indication of the meaning of the broad principle of accommodating commerce and business. These further guides are to be found in section 13 of the Federal reserve act, where the purposes for which Federal reserve credit may be provided are described as ‘agricultural, industrial, or commercial purposes.’ It is clear that the accommodation of commerce and business contemplated as providing the proper occasion for the use of the credit facilities of the Federal reserve banks means the accommodation of agriculture, industry, and trade. The extension of credit for purposes ‘covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States,’ is not permitted by the Federal Reserve act. The Federal reserve system is a system of productive credit. It is not a system of credit for either investment or speculative purposes. Credit in the service of agriculture, industry, and trade may be described comprehensively as credit for productive use. The exclusion of the use of Federal reserve credit for speculative and investment purposes thus clearly indicates the nature of the tests which are appropriate as guides in the extension of Federal reserve credit. They clearly describe the nature or character of the purposes for which such credit and currency may be extended. The qualitative tests appropriate in Federal reserve bank credit administration laid down by the act are, therefore, definite and ample.

“But the problem of credit and currency administration implies the use not only of qualitative tests but also of quantitative tests. By what means may it be known whether the volume of credit provided by the Federal reserve banks is in any given set of circumstances adequate, excessive, or deficient? The problem in good administration under the Federal reserve system is not only that of limiting the field of uses of Federal reserve credit to productive purposes, but also of limiting the volume of credit within the field of its appropriate uses to such amount as may be economically justified—that is, justified by a commensurate increase in the Nation’s aggregate productivity. The Board is fully aware of the fact that the problem of credit extension involves the question of amount or volume as well as the question of kind or character; otherwise stated, involves a *quantitative* as well as a *quali-*

*tative* determination. But it is the view of the Board that it is not necessary to go outside of the Federal reserve act to find suitable methods of estimating the adjustment of the volume of credit provided by the Federal reserve banks to the volume of credit needs. The Federal reserve act itself suggests the nature of the tests, guides, or indicators—whatever they may be called—to be used in gauging the need for and the adequacy of Federal reserve credit. The provisions of the act already quoted indicate that the needs for credit which are recognized by the act as appropriate are those derived from agriculture, industry, and trade. It is the belief of the Board that there will be little danger that the credit created and contributed by the Federal reserve banks will be in excessive volume if restricted to productive uses.

“A characteristic of the good functioning of the economic system is to be found in the smooth unobstructed movement of goods from the producer through the channels of distribution to their several ultimate uses. The characteristics of the good functioning of the credit system is to be found in the promptness and in the degree with which the flow of credit adapts itself to the orderly flow of goods in industry and trade. So long as this flow is not interrupted by speculative interference there is little likelihood of the abuse of credit supplied by the Federal reserve banks and consequently little danger of the undue creation of new credit. The volume of credit will seldom be at variance with the volume of credit needs as they are reflected in the demands of productive industry as long as (1) the volume of trade, production, and employment, and (2) the volume of consumption are in equilibrium. Credit for short-term operations in agriculture, industry, and trade, when these operations are genuinely productive and non-speculative in character, that is to say, credit provided for the purpose of financing the movement of goods through any one of the successive stages of production and distribution into consumption, is a productive use of credit. But when the effect of the credit used is to impede or delay the forward movement of goods from producer to consumer, unless such delay is made necessary by some unavoidable cause, e.g., the interruption of transportation facilities, credit is not productively used. The withholding of goods from sale when there is a market or the accumulation of goods for an anticipated rise of price is not a productive use. It is the nonproductive use of credit that breeds unwarranted increase in the volume of credit; it also gives rise to unnecessary maladjustment between the volume of production and the volume of consumption, and is followed by price and other economic disturbances. Administratively, therefore, the solution of the economic problem of keeping the volume of credit issuing from the Federal reserve banks from becoming either excessive or deficient is found in maintaining it in due relation to the volume of credit needs as these needs are derived from the operating requirements of agriculture, industry, and trade, and the prevention of the uses of Federal reserve credit for purposes not warranted by the terms or spirit of the Federal reserve act.

“There are no automatic devices or detectors for determining, when credit is granted by a Federal reserve bank in response to a rediscount demand, whether the occasion of the rediscount was an extension of credit by the member bank for nonproductive use. Paper offered by

a member bank when it rediscounts with a Federal reserve bank may disclose the purpose for which the loan evidenced by that paper was made, but it does not disclose what use is to be made of the proceeds of the rediscount. A farmer's note may be offered for rediscount by a member bank when in fact the need for rediscounting has arisen because of extensions of credit by the member bank for speculative use. Similarly, the note of a member bank collateralized by United States Government securities may be offered for discount to a Federal reserve bank when in fact the proceeds are to be used in supporting the extension of credit for 'agricultural, industrial, or commercial purposes.' Protection of their credit against speculative uses requires that the Federal reserve banks should be acquainted with the loan policies and credit extensions of their member banks—such acquaintance as can be obtained by examination of their member banks or by other forms of contact with them. In brief, the technical administrative problem presented to each reserve bank is that of finding the ways and means best suited to the circumstances in which it operates of informing itself of when and to what extent the extension of credit for speculative uses is the real occasion of member bank rediscounting.

"The administrative problems presented to the Federal Reserve Board are of different character and require a different technique. Unlike the Federal reserve banks, the Federal Reserve Board makes no loans. It is not an operating body, but a supervising body. As a supervising body it is not primarily concerned with the detail of the transactions of the Federal reserve banks. Its concern lies rather with the total volume and the aggregate effects of the credit transactions of the Federal reserve banks. In the discharge of the responsibility placed upon it by the act for the 'review and determination' of the discount policy and discount rates of the Federal reserve banks 'with a view of accommodating commerce and business,' the Federal Reserve Board must look for guidance primarily to information concerning the state of industry and trade and the state of credit. Changes in the volume of bank credit in use are the outcome of changes in the volume of business. A proper and effective credit policy, considered in its broader aspects must, therefore, be based on that wide variety of economic facts which, when brought together throw light on the changes taking place in the business situation and their relation to current banking and credit trends.

"While statistical information concerning production and distribution, covering the whole range of business activity from producer to consumer, is not complete, it is sufficient to indicate currently the rate at which goods are being produced and marketed. Information of this character, as a result of the growing recognition of its value and of the activities in collecting such information both by governmental and private agencies, is now available more currently and in more lines of industry and trade than ever before. The changes from month-to-month recorded in these figures, when brought together and inter-

puted, indicate the nature and rate of readjustments which are constantly taking place in the industrial and business situation. The activity of business, as measured by these current statistics, is the outcome of the decisions and actions of a large number of individual business men. They are, to be sure, in form and in substance an account of the immediate past, but they also give indications of the conditions affecting the course of business in the future. While this information does not make it possible to measure or estimate in advance the probable aggregate volume of credit needs or to combine into any single formula the elements of judgment applicable to varying credit situations as they arise, it provides basic data needed in banking administration. No statistical analysis can ever be a substitute for judgment in matters of credit administration, but such analyses of economic conditions are indispensable as furnishing the factual basis for credit judgment and for the development of credit policy.

“In view of the importance of this information in the determination of credit policy the Board and the Federal reserve banks collect through their statistical organizations, in addition to current reports on banking and credit conditions, basic economic data bearing on changes in the volume of production, trade, and employment, and the movement of prices both in the United States and abroad. The volume of production in physical units indicates the extent of industrial activity and measures the output of goods which will subsequently come into the market. Monthly data are available for basic industries, and while fluctuations in volume of production in these industries are wider than those in the total for all industries, the data are sufficiently representative to indicate at any given time the direction and trend of industrial activity. Changes in the volume of employment at industrial establishments, figures for which are available for a larger number of industries, not only reflect the degree of current productive activity and thus supplement the figures on production, but because of their bearing on the earnings of workers, also indicate changes in the purchasing power of a large body of consumers. It is the buying power of consumers which primarily determines the demand for goods and the rate at which current production can be maintained. The movement of goods into the hands of final purchasers is measured by the volume of retail buying, which for many lines of trade throughout the country is reported monthly. The rate at which goods are moving through the intermediate channels of distribution is reflected in the volume of wholesale trade and of the shipment of merchandise. A smooth distribution of goods requires that stocks of raw materials and merchandise shall be held at different points in the marketing process, and the extent to which the marketing is orderly—that is, without undue accumulation or exhaustion of stocks—is shown in the changes in the volume of stocks held by producers and distributors. While information concerning stocks is not yet as complete or as current as informa-

tion on production and trade, it is now available for many commodities and is steadily becoming more satisfactory.

“Since the purpose of the Board and of the Federal reserve banks in collecting and compiling this current economic information is to measure changes in the volume of production and trade in relation to changes in the volume of credit, the various lines of information are put into the form of index numbers for purposes of comparison. The use of index numbers, by placing the wide variety of information on a common basis, makes possible comparisons of the direction and rate of change in their basic industrial and commercial activities in their relation to credit trends.

“In the current surveys of business conditions published by the Board and the Federal reserve banks, the economic data which they collect are made available to the business community. These publications and the activities of other Government and private agencies in the gathering and interpretation of information with reference to current economic conditions are contributing to a better understanding of the factors at work in the business situation and a better appreciation of the relation between business movements and the volume of credit. The business community from which the demand for credit arises is in a position, on the basis of the more adequate information now available, to shape its policies with reference to the use of credit in accordance with fundamental factors and thus to cooperate with banking authorities in the maintenance of sound credit conditions.

“The circumstances which have unavoidably led central banking administrations in all countries to exercise a more direct judgment concerning credit conditions and needs than was necessary in periods when the gold standard functioned as an effective regulator of international trade and financial movements have been discussed earlier in this report. Under the conditions that formerly obtained, action of a central bank was largely determined by forces that were registered in changes in its reserve position. No test so simple, so definite, so easily understood, and so practicable has been found, nor is likely to be found, as the old reserve ratio. The banking and business community in prewar days, looking at the position of the central bank—that is, the state of its reserve and the position of its reserve ratio—could see for itself what the state of credit was and what course of action was indicated. The business community could, therefore, closely approximate both the kind of action and the time of action to be taken by central banking authorities. In circumstances which made necessary the protection of their gold reserves, little scope was left for the exercise of large discretion. Under present conditions, however, and until the restoration in some form of the international gold standard, discretion must inevitably play a larger role in central banking administration than in pre-war days when more reliance could be placed on changes in the reserve ratio. There is much evidence that this altered situation in which the banking community finds itself is being more

fully understood by the general business and borrowing public, and that a more intelligent comprehension of present day credit problems is resulting.

“The more fully the public understands what the function of the Federal reserve system is and on what grounds and on what indications its policies and actions are based, the simpler and easier will be the problems of credit administration in the United States. For this reason it has been the policy of the board to inform the public, either through its official monthly publication or by statements to the press, on matters in which the public has an interest and to which its attention should be drawn. By this means the Board presents to the public a statement of the problems confronting the system and of the attitude of the Board toward current banking and credit developments. The public is a partner in the Federal reserve system. The cooperation of the public based upon an understanding of the broad outlines of Federal reserve credit policy is of the greatest advantage to a good functioning of the system. The difficulties and disturbances which have confronted business men, both in this country and abroad, during the period of post-war readjustments, have obliged them to take cognizance of the fundamental factors which influence the movement of trade and industry and of the relation between these factors and the volume of credit. In the United States more than in any other country business men in recent years have shown a disposition to use current statistical data measuring the rate and movement of basic factors in the economic situation and to adjust the policies of their individual business enterprises to the underlying economic forces. The Federal reserve system in developing its policies is also in a position to use as guides these indicators of changes in the state of industry and trade, and with the increasing public appreciation of the value and meaning of these guides will to a larger degree have the cooperation of an informed public opinion in the carrying out of its policies. It is the belief of the Board that out of the experience of the United States and other countries that are now endeavoring to adapt their banking systems to the changing conditions and needs of industry during this period of unprecedented disturbance, there may result a larger conception of the function of these banking systems and the development of a new and more competent basis of credit administration.”

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## APPENDIX B

### THE TRADITION OF SECRECY IN FEDERAL RESERVE DELIBERATIONS

After Secretary Mellon took office in 1921, there was a marked increase in the frequency of “off the record” discussions, even though Minutes of proceedings were not accessible to anyone outside the System. As the following excerpts from Governors’ Conferences dur-

ing 1922 and 1923 indicate, open market operations and Treasury policies were the two areas most frequently treated confidentially:

“There was a long discussion of practices of the several reserve banks and an expression of views of their obligations as fiscal agents. It was understood that the conference would, on the next day, consider the desirability of adopting a policy of buying and selling Government obligations in an orderly, systematic way, not solely with regard to earnings, but with regard to the whole credit situation and to the interests of the Treasury. (See paragraphs 2, 16, 59, 64.)

“At this point the conference went into executive session (stenographer absent) and confidential matters were discussed. (*Summary*, May, 1922 Conference, p. 10.)”

\* \* \* \* \*

“In executive session (stenographer absent) the Chairman reported the substance of his conversation with Secretary Mellon in respect to matters which the Conference had requested him to discuss with the Secretary (See paragraph 27). (*Summary*, May, 1922 Conf., p. 27.)”

\* \* \* \* \*

“(Executive discussion followed, at the conclusion of which the Chairman submitted to the meeting the cables recently exchanged between the Federal Reserve Bank of New York and the Bank of England in regard to attendance at conference of representatives of the European Banks of Issue, the matter being discussed in conference without any record being kept of it.) (*Stenographic Record*, May, 1922 Conf., p. 235.)”

\* \* \* \* \*

“Mr. Gilbert (Treasury Undersecretary). The Treasury looks on these holdings by the reserve banks necessarily as a whole. It is not a question of ten million here or fifty million there, but merely a question of having three or four hundred million—at one time over five hundred million—in substantially one lot on an over-handing market, or in a position to overhang the market, because the transactions of both purchases and sales are immediately reflected in the central market in New York. We have always felt that the Federal Reserve banks were perhaps a little unduly nervous about earnings when they invested, particularly for the reason that in the ordinary course of business there will be a certain amount of actual business, transactions of purchase and sale, during a temporary period of tightening of money, or otherwise they will result in a temporary investment which will be cleaned out automatically.

“(Further informal discussion followed, which the Chair directed should not be reported, at the conclusion of which, at 5:40 o'clock p.m., the Conference adjourned until 10 o'clock Thursday, October 12, 1922, at which time they were to go into joint conference with the Chairmen of the Federal Reserve Banks and the Federal Reserve Board.) (*S.R.*, October, 1922 Conf., p. 439.)”

\* \* \* \* \*

"The Chairman submitted for the consideration of the conference a memorandum prepared by the Federal Reserve Board X-3675— (printed pages 517-520 stenographic record) concerning open market operations, which was considered at some length, off the record. The matter was informally discussed with some of the members of the Board and also with Mr. Gilbert. No action was taken. (*Summary*, March, 1923 Conf., p. 19.)"

\* \* \* \* \*

"In addition to various matters of general policy (of which it is the practice to keep no Secretary's minutes) and other topics which were generally discussed without conclusions being reached, the following matters which had either been specifically referred to the Governors by the Board or held over for discussion with the Board were considered. (*Summary*, March, 1923 Conf., p. 23.)"

\* \* \* \* \*

"The CHAIRMAN. Gentlemen, Mr. Gilbert suggested that we give some further consideration to the question of permitting our Government securities to run off, or, I assume, permitting him to retire them when he is able, at the pleasure of the Treasury. Do you wish to discuss that now, or do you desire to wait until the matter comes up, as the Secretary says it will, in our conference with the Board?"

"Governor FANCHER. That will come up in connection with Dr. Miller's memorandum on the question of the formation of a new committee.

"Governor CALKINS. It might be well for us to discuss it anyhow.

"The CHAIRMAN. The secretary says it will come up in our conference with the Board.

"Governor CALKINS. Notwithstanding the fact that it will come up there, is it not more or less desirable for us to discuss it before that time, to see if we can arrive at any conclusion?"

"The CHAIRMAN. It seems to be your opinion that it is desirable, and consequently we will ask you to express your views, Governor Calkins.

"(Discussion followed which the reporter was directed not to take.)

"The CHAIRMAN. Now, if there is no further discussion on this, we will postpone it until such time as the question may come up with the Board, and we will go on with our program.

"We have finished a discussion of fiscal agency topics . . . (*S.R.*, March, 1923 Conf., pp. 285-286.)"

\* \* \* \* \*

"The CHAIRMAN. Gentlemen, we will proceed to discuss the subject matter of the Board's communication X-3675 [creating the Open Market Investment Committee].

"Upon direction of the conference no record was made of the discussion of this matter.

"The CHAIRMAN. We will now discuss the second memorandum from the Board, X-3676. (*S.R.*, March, 1923 Conf., p. 521.)"

## APPENDIX C

### FEDERAL RESERVE BANKS—GROSS OPEN MARKET PURCHASES AND YEAREND HOLDINGS OF SECURITIES

[In millions of dollars]

	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924	1925	1926	1927	1928
<b>Gross purchases: <sup>1</sup></b>														
Acceptances <sup>1</sup> .....	65	386	1,078	1,810	2,825	3,218	1,534	1,955	2,547	2,172	2,961	3,353	4,051	4,240
U.S. Government securities <sup>2</sup> .....	16	57	89	5,850	4,738	7,988	3,847	4,633	3,501	2,257	2,317	2,608	6,356	1,197
Municipal warrants <sup>3</sup> .....	66	91	17	2			1	( <sup>4</sup> )	1	( <sup>4</sup> )				
<b>Total</b> .....	<b>147</b>	<b>534</b>	<b>1,184</b>	<b>7,662</b>	<b>7,563</b>	<b>11,206</b>	<b>5,382</b>	<b>6,588</b>	<b>6,049</b>	<b>4,444</b>	<b>5,329</b>	<b>5,992</b>	<b>10,677</b>	<b>5,437</b>
<b>End-of-year holdings: <sup>2</sup></b>														
U.S. Government securities .....	16	55	122	239	300	287	234	436	134	540	375	315	617	228
Other securities .....	12	9	5	( <sup>4</sup> )			( <sup>4</sup> )	( <sup>4</sup> )	( <sup>4</sup> )	2	3	3	1	10
Bills bought .....	24	129	273	287	574	260	145	272	355	387	374	381	392	489
	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938	1939	1940	1941	1942
<b>Gross purchases: <sup>1</sup></b>														
Acceptances <sup>1</sup> .....	3,587	3,874	2,998	763	898	76	31	25	25	3	2			
U.S. Government securities <sup>2</sup> .....	870	2,408	2,259	3,679	3,139	2,671	2,060	1,610	1,618	3,606	1,862	66	344	5,107
Municipal warrants <sup>3</sup> .....	( <sup>4</sup> )	1	3	( <sup>4</sup> )										
<b>Total</b> .....	<b>4,457</b>	<b>6,283</b>	<b>5,260</b>	<b>4,442</b>	<b>4,037</b>	<b>2,747</b>	<b>2,091</b>	<b>1,635</b>	<b>1,643</b>	<b>3,609</b>	<b>1,864</b>	<b>66</b>	<b>344</b>	<b>5,107</b>
<b>End-of-year holdings: <sup>2</sup></b>														
U.S. Government securities .....	511	729	817	1,855	2,437	2,430	2,431	2,430	2,564	2,564	2,484	2,184	2,254	6,189
Other securities .....	12	7	31	5	1		( <sup>4</sup> )							
Bills bought .....	392	364	339	33	133	6	5	3	1	1				

	1943	1944	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956
<b>Gross purchases: <sup>1</sup></b>														
Acceptances <sup>1</sup> .....			1	69	4				2				176	259
U.S. Government securities <sup>2</sup> .....	8,611	25,142	35,911	40,935	21,628	22,477	9,425	19,582	7,594	5,829	2,175	2,903	2,176	3,125
Municipal warrants <sup>3</sup> .....														
<b>Total</b> .....	8,611	25,142	35,912	41,004	21,632	22,477	9,425	19,582	7,596	5,829	2,175	2,093	2,352	3,384
<b>End-of-year holdings: <sup>2</sup></b>														
U.S. Government securities .....	11,543	18,846	24,262	23,350	22,559	23,333	18,885	20,778	23,801	24,697	25,916	24,932	24,785	24,915
Other securities .....														
Bills bought .....													28	69
	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
<b>Gross purchases: <sup>1</sup></b>														
Acceptances <sup>1</sup> .....	265	357	338	331	282	418	635	1,557	1,795	2,939	2,275	1,850	2,837	3,589
U.S. Government securities <sup>2</sup> .....	2,407	6,754	2,866	4,685	9,015	9,829	8,789	10,454	9,888	15,651	12,643	28,295	34,473	24,539
Municipal warrants <sup>3</sup> .....														
<b>Total</b> .....	2,672	7,111	3,204	5,016	9,387	10,247	9,424	12,011	11,683	18,590	14,918	30,145	37,310	28,128
<b>End-of-year holdings: <sup>2</sup></b>														
U.S. Government securities .....	24,238	26,347	26,648	27,384	28,881	30,820	33,593	37,044	40,768	44,282	49,112	52,937	57,154	62,142
Other securities .....										34	38			
Bills bought .....	66	49	75	74	51	110	162	94	187	193	164	58	64	57

<sup>1</sup> Acceptances includes both outright purchases and repurchase agreements. After 1939, acceptances refer only to bankers' acceptances.

<sup>2</sup> Gross purchases of U.S. Government securities are as of the last Wednesday of the year for 1928-40.

<sup>3</sup> Federal Reserve banks did not hold municipal warrants after 1933.

<sup>4</sup> Less than \$500,000.

Source: Annual reports of the Federal Reserve Board, Banking and Monetary Statistics, and the archives of the Federal Reserve Bank of New York.